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INDONESIA:	Was the Devaluation too Large?
JAPAN:	The Economics of Restructuring.
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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

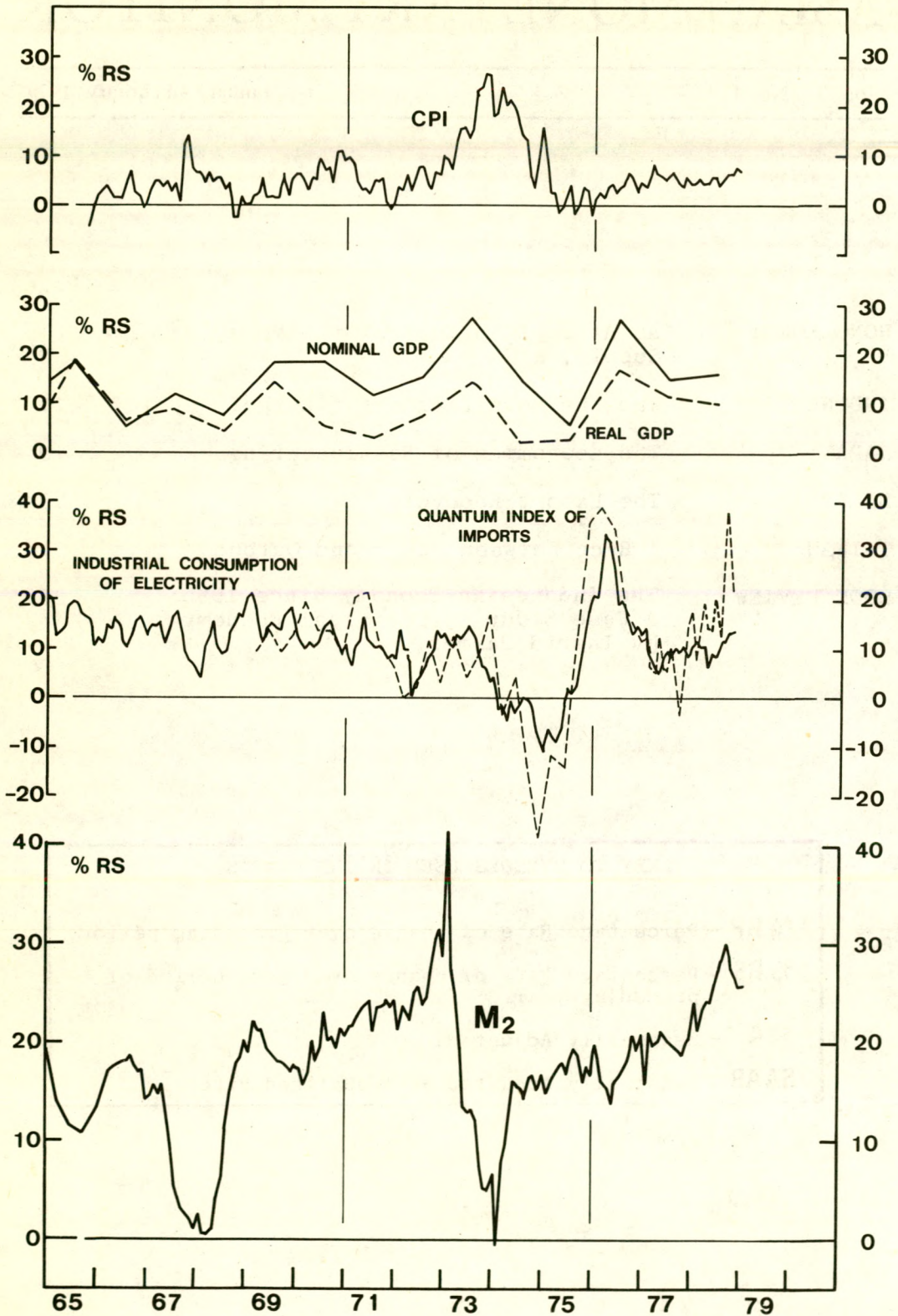
% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

HONG KONG

CHART 1 : MONEY, OUTPUT INDICATORS, AND PRICES



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AN ATTEMPT TO CONTROL THE MONEY SUPPLY

The 1979 Hong Kong budget was a milestone in the economic policy of the government. For the first time the government recognised that the aggregate demand for goods and services is determined by the conduct of monetary policy in Hong Kong. The neglect of monetary factors in the past led the Financial Secretary to underestimate grossly the level of demand and the inflationary pressures which were building up in the economy in 1977 and 1978, with the result that no measures were taken to control monetary expansion until the stability of the financial system was threatened. Although some corrective measures were proposed in the budget, the failure to restrain monetary expansion since the floating of the exchange rate in 1974 has already unleashed powerful inflationary forces. As a consequence, no matter what corrective actions are taken, they are almost certain to be painful and damaging to some sectors of the economy.

No matter what steps are taken, it is now too late to prevent consumer price inflation reaching well into double-digit rates in 1979. A monetary squeeze engineered by hastily improvised ad hoc government measures must lead to interest rates shooting up. If the squeeze is very tight borrowers will be hit severely and the property sector will suffer. If there is no monetary squeeze the Hong Kong dollar will be under further pressure to depreciate, and restraining measures will be all the more urgent later on. There is almost no option left to the government other than to force a monetary squeeze.

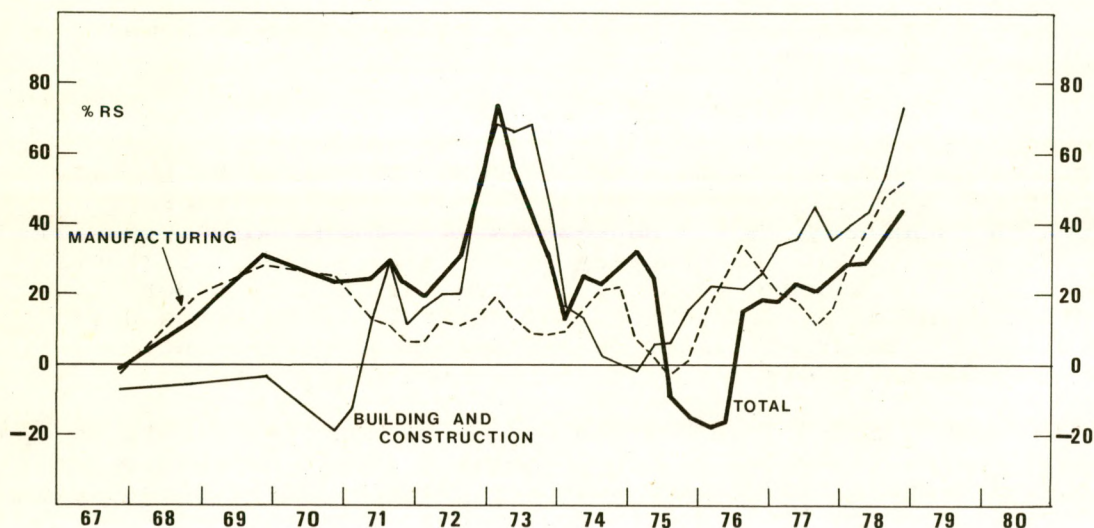
Charts 1 and 3 show how the explosive monetary growth in 1978 is being reflected in accelerating economic activity, rocketing imports and rising consumer prices. The increases in interest rates in the past six months bear more than a coincidental similarity to the episode of 1973. On both occasions a period of highly inflationary monetary growth was followed by a slowdown in the money aggregates, but Chart 2 shows that the growth of domestic loans has not yet been affected by the monetary restraint. As a result the domestic loans/deposits ratio has shot up to nearly the same level as in 1973. Despite the claims by some that the property sector is now more cautious and less leveraged than in the past, the rate of growth of bank lending to the building and construction sectors has been higher than at any time in the past twelve years.* The government has recognised its responsibility to restrain aggregate demand far too late.

Although the government now realises that the monetary system cannot be left to drift if the exchange rate is allowed to float, it still has not set up a satisfactory system. The

* In December 1978, building and construction loans had risen 73% from one year earlier and 134% from two years earlier. The previous highest figures were for September 1973 when loans to this sector were up 68% in one year and 102% in two years respectively.

change in the reserve requirements against Exchange Fund short-term deposits which was announced in the budget speech is inadequate and ill-thought out, and leaves the major faults in the present system untouched. As a result, even though the authorities will attempt to restrain monetary growth in the next six months, there is no guarantee of their ability to do so. They have fashioned a blunt and clumsy instrument with which to do what is probably the most important task before the government today. There is a very real danger that they will squeeze either too much or not enough.

HONG KONG
CHART 2: LOANS AND ADVANCES



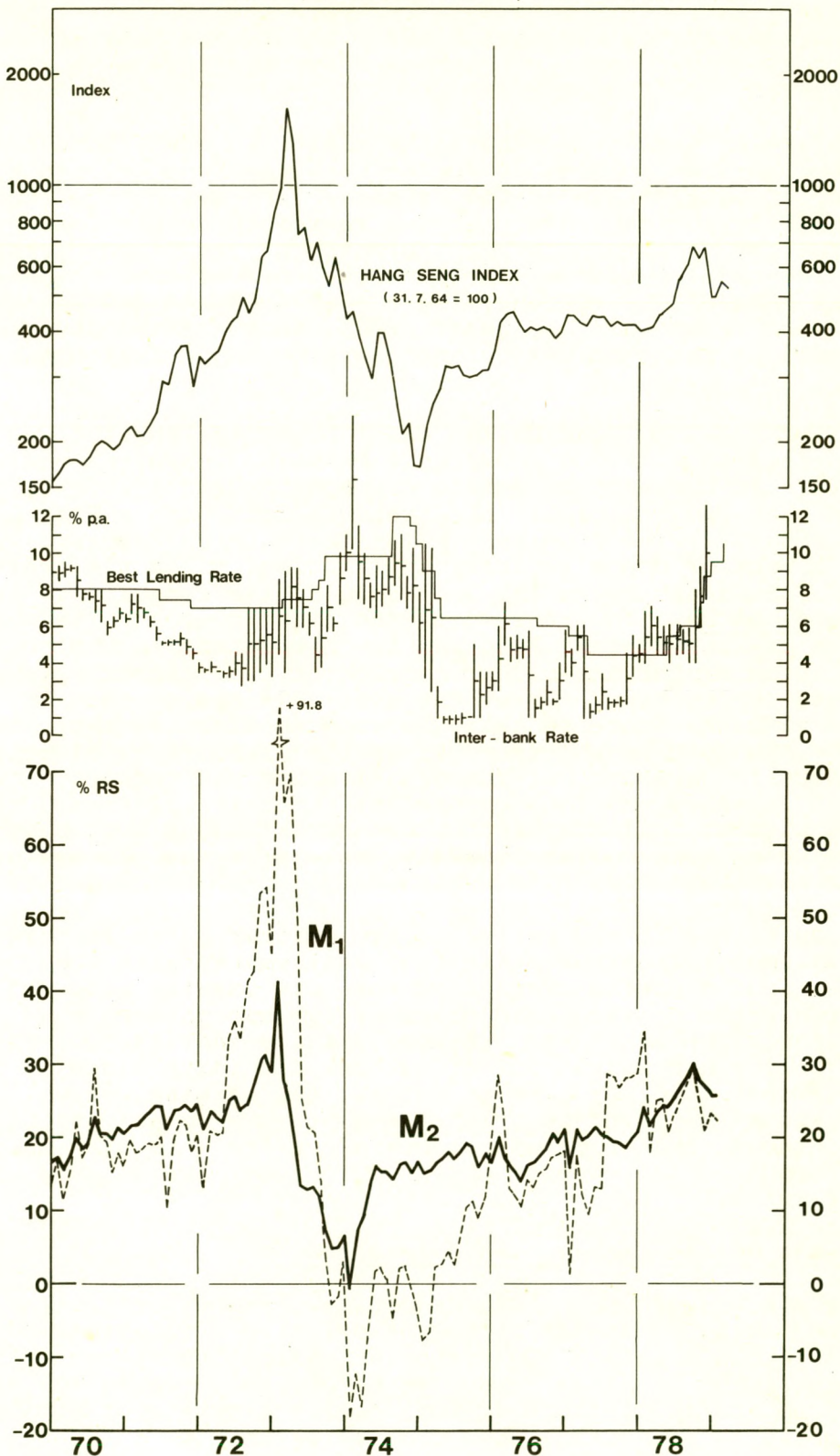
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Unfortunately in order to gain an understanding of the effects and limitations of the government's new measures it is necessary to analyse in some technical detail the operations of the monetary system.

To begin with it is worth restating the reasons for the escalating monetary expansion in Hong Kong. There are two quite separate factors at work, and the government has dealt with only one of them. One source of inflation was the note-issuing mechanism, the second was that the banks have unrestrained access to reserve assets. The government has only dealt with the problem of the note issue.

HONG KONG

CHART 3 : MONEY, INTEREST RATES, AND STOCK PRICES



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The note-issuing mechanism

Firstly, by administrative short-sightedness, when the Hong Kong dollar was floated in 1974 the mechanism by which the currency is issued in Hong Kong was converted into an engine of inflation.

Before 1974 whenever the banks wished to issue more cash currency they had to give up to the Exchange Fund foreign currency of equal value at the exchange rate set by the Fund. Their ability to issue new cash was therefore constrained by their ability to obtain foreign currency at the fixed exchange rate. The banking system lost foreign reserves when it created new Hong Kong dollar currency and thereby reduced its assets by an amount corresponding to the increase in the note-issue, with no overall increase in assets and therefore no inflationary impact.

After the Hong Kong dollar was floated the regulations were changed so that the commercial banks no longer needed to remit foreign currency to obtain new Hong Kong dollar cash. Instead they can now credit the Exchange Fund with a Hong Kong dollar deposit. The important point is that the Exchange Fund is not a bank or deposit-taking institution and in the ordinary course of business holds its Hong Kong dollar deposits at the commercial banks. In other words the banks keep both the deposits of the Exchange Fund and the new banknotes, which is in violation of the age-old principle that you cannot get something for nothing. Under the post-1974 system the commercial banks increase their balance sheets when they increase the note issue, because, on the liabilities side, the note issue is expanded but the deposits are not reduced. The issue of currency has thus become inflationary. It means that perhaps without realising it the commercial banks have been creating Hong Kong dollar liquidity merely in the process of issuing new banknotes.

Despite widespread belief to the contrary, the fact that the government fiscal accounts (now amalgamated with the Exchange Fund deposits created by the note-issuing process) are also within the commercial banking system has no long run inflationary implications. It merely means that the governments' fiscal policy has little effect on bank liquidity since it does not put money into, or take it out of, the banking system. In this respect the government is like a private company (albeit large); the accumulation of corporate profits in a bank account is analogous to the effects of the government budget surplus. Neither is inflationary.

The effect of the Exchange Fund Amendment

In his budget speech Mr. Haddon-Cave announced that he would be making an amendment to the existing regulations to make the banks maintain 100% reserves against short-term deposits of the Exchange Fund. In effect this regulation can be used to sterilize the Hong Kong dollar deposits of the Exchange Fund, preventing them from being used to expand the credit of the banking system. If the government wishes to

restrain credit expansion but at the same time the banks wish to increase the note issue, the banking system will in future have to put up more reserves to hold against the increased short-term deposits of the Exchange Fund. The commercial banks must therefore give up some credit expansion in order to obtain the new notes. They will no longer get something for nothing, and the inflationary effect of the note issue will be avoided.

The control of monetary reserves

Unfortunately, the note-issuing mechanism was not the only flaw in the system. The major defect remains. Changing the reserve ratios against certain Exchange Fund deposits does nothing to restrain the total supply of reserves. There is little point in requiring the banks to hold more reserves if the acquisition of reserves is unrestrained, yet that is the situation prevailing in the Hong Kong banking system.

Now, reserve assets* are all liquid and therefore fulfil the function of providing a cushion for the banking system against unexpected commitments, banking panics etc. but the supply of these assets is enormous, and could in theory be used as a basis for inflationary credit expansion. In particular the pool of foreign currency assets available to the banks is readily accessible because there are neither foreign exchange controls nor a fixed exchange rate. Because the price of foreign currency (the exchange rate) is allowed to float, the rate of acquisition of foreign assets by the public and the banks can be whatever they wish. A strong demand for foreign assets will be met by an increased supply of foreign currency in the foreign exchange markets because the exchange rate of the Hong Kong dollar will be bid downwards until the supply of foreign currency is sufficient to meet the demand.

An excessive rate of expansion of the money supply and the concomitant excess demand in the economy need not therefore lead to a depletion of foreign reserves through balance of payments outflows. A net inflow of foreign currency can be maintained at the price of a falling exchange rate. Commercial bank holdings of foreign assets can therefore grow at any rate and provide the base for continued credit expansion.

* Briefly, after netting out interbank balances, reserves are defined as:

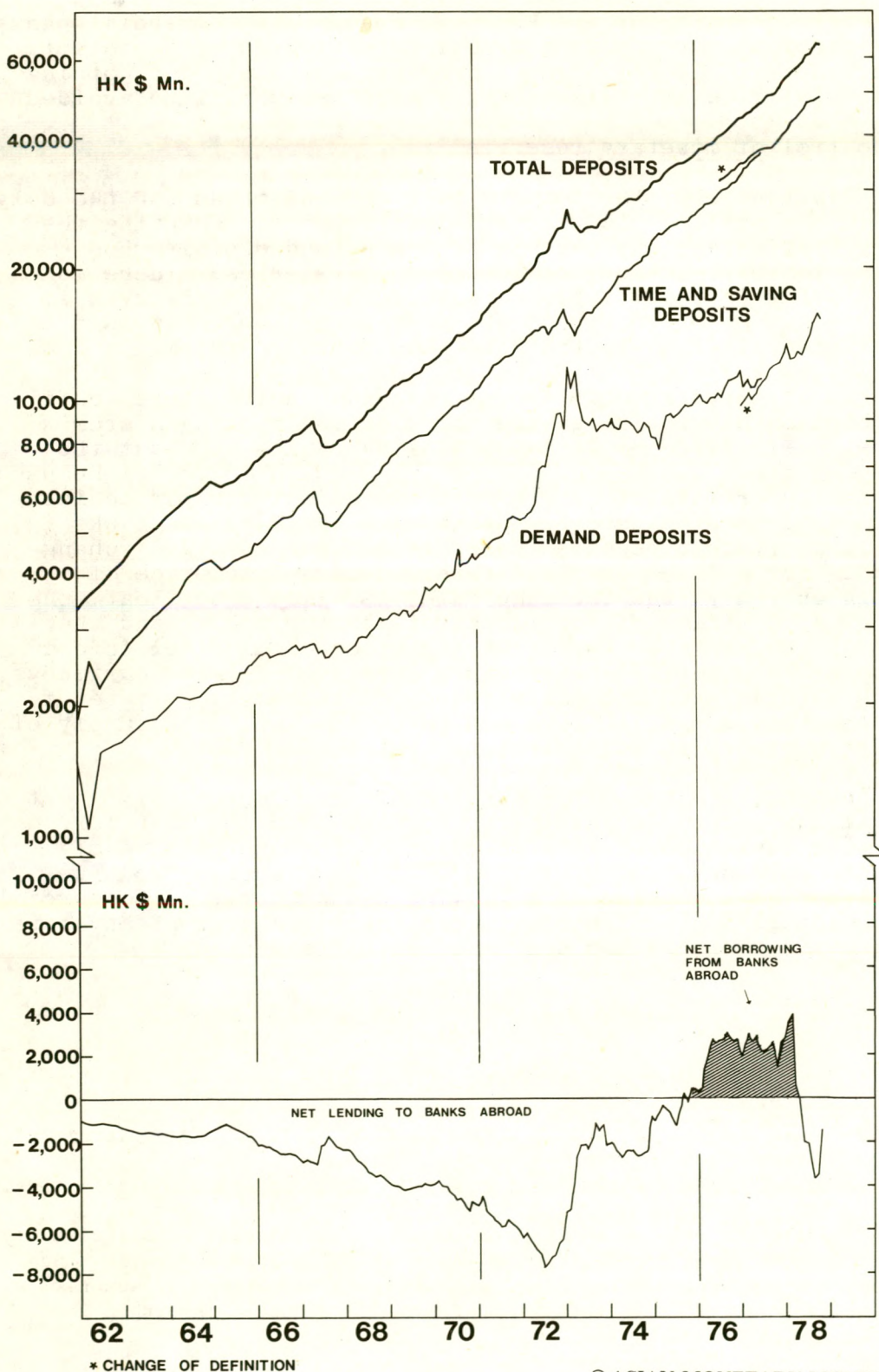
- 1) Hong Kong dollar cash
- 2) Gold
- 3) Liquid foreign currency assets guaranteed by a foreign government.

The sum of these reserves must equal 15% of total deposit liabilities.

An additional reserve equal to at least 10% of deposit liabilities may be held in any of the forms listed above or in bills of exchange in Hong Kong dollars or foreign currencies, or in marketable government securities of maturity less than five years provided they are quoted in either Hong Kong, London or New York.

HONG KONG

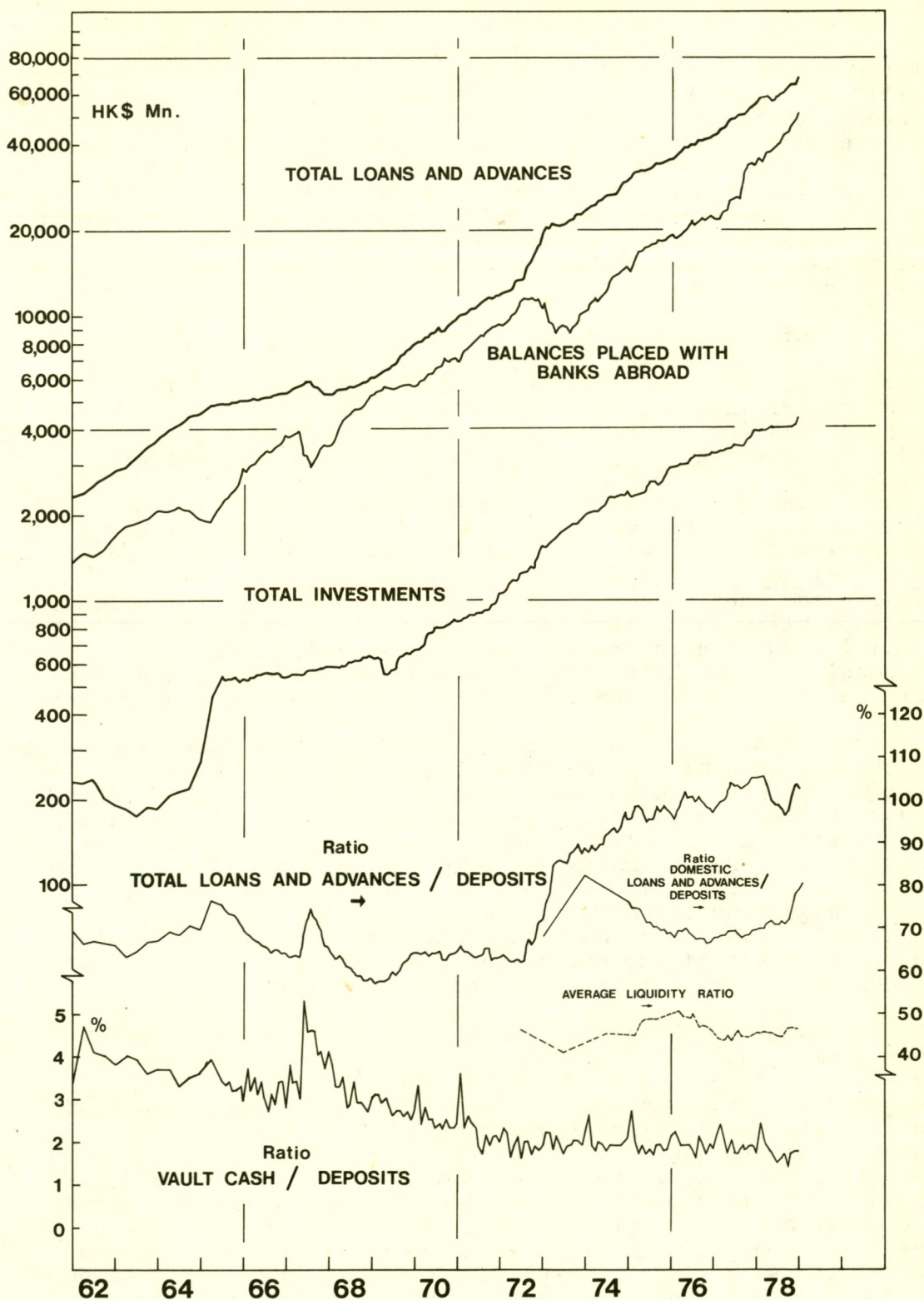
CHART 4 : BANK LIABILITIES



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HONG KONG

CHART 5 : BANK ASSETS



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To illustrate this point we can follow the various effects of the new amendment to the Exchange Fund regulations, and show how it gives the government at best a feeble and temporary influence on monetary growth.

Suppose the government, alarmed by the rate of expansion of the money supply, shifts some of the Exchange Fund Hong Kong dollar deposits into short term deposits. The banks must then increase their holdings of liquid reserves to meet the new reserve requirements and they duly reduce their loans. So far so good. The desired effect - a reduction in credit expansion and deposits - is achieved, but that is not the end of the matter. Suppose the increased liquid asset holdings could obtain a higher return if held in the form of U.K. Treasury bills. The banks would then endeavour to sell the Hong Kong dollars to buy sterling.

Now since the Hong Kong dollars are merely exchanged, not destroyed, they remain liabilities of the banking system, and there is no change in the total value of Hong Kong dollar deposits arising from the foreign exchange transactions. The banks obtain the desired foreign currency by bidding up the price of sterling (i.e. bidding down the Hong Kong dollar exchange rate). Once again the banks are obtaining new assets - the U.K. Treasury bills - without having to reduce their deposit liabilities. They now have both the extra U.K. Treasury bills to meet the higher reserve requirements and the Hong Kong dollar deposits with which they bought them. In other words they can now relend the Hong Kong dollars while the Treasury bills look after the raised reserve requirements. The initial reduction in credit expansion caused by the calling in of loans to raise liquidity is thereby counteracted as soon as foreign assets are purchased to meet those reserve requirements.

The raising of reserve requirements is therefore circumvented by the purchase of foreign currency assets by the banking system. Higher reserve requirements are only effective if the banks choose to hold the extra reserves in Hong Kong dollars. The relative desirability (and availability) to the banks of Hong Kong dollar reserve assets and eligible foreign reserve assets is thus of crucial importance to the effectiveness of the use of Exchange Fund deposits in regulating the money supply. Neither the government nor the public can confidently predict what the effect of the new policy instrument will be, because it depends on the behaviour of the banks.

In summary, the alteration to the Exchange Fund regulations is a clumsy, unreliable and inadequate attempt to curb credit expansion. It embodies two of the worst characteristics of governmental intervention in that it is both discretionary and unreliable. It is discretionary in that it depends on the movement of Exchange Fund deposits between short and long term maturities at the discretion of public administrators and therefore it is subject to the limitations of their abilities and motives. It is unreliable in that nobody can be sure of the effects of these actions on the monetary system. But the most serious failing is that it does not address the fundamental problem which is that the reserves of the monetary system remain unrestrained and uncontrolled.

In the next issue of AMM various proposals for the reform of the Hong Kong monetary system will be discussed.

INDONESIA

WAS THE DEVALUATION TOO LARGE?

Indonesia has taken one of the most daring steps in her economic policy since the recovery from hyperinflation of the mid sixties. On November 15, 1978 the Indonesian rupiah was devalued from 415 to the dollar to 625 to the dollar - a massive 33.6% devaluation. The devaluation came after rumours of revaluation and devaluation circulated widely, but few people expected a devaluation of such a magnitude.

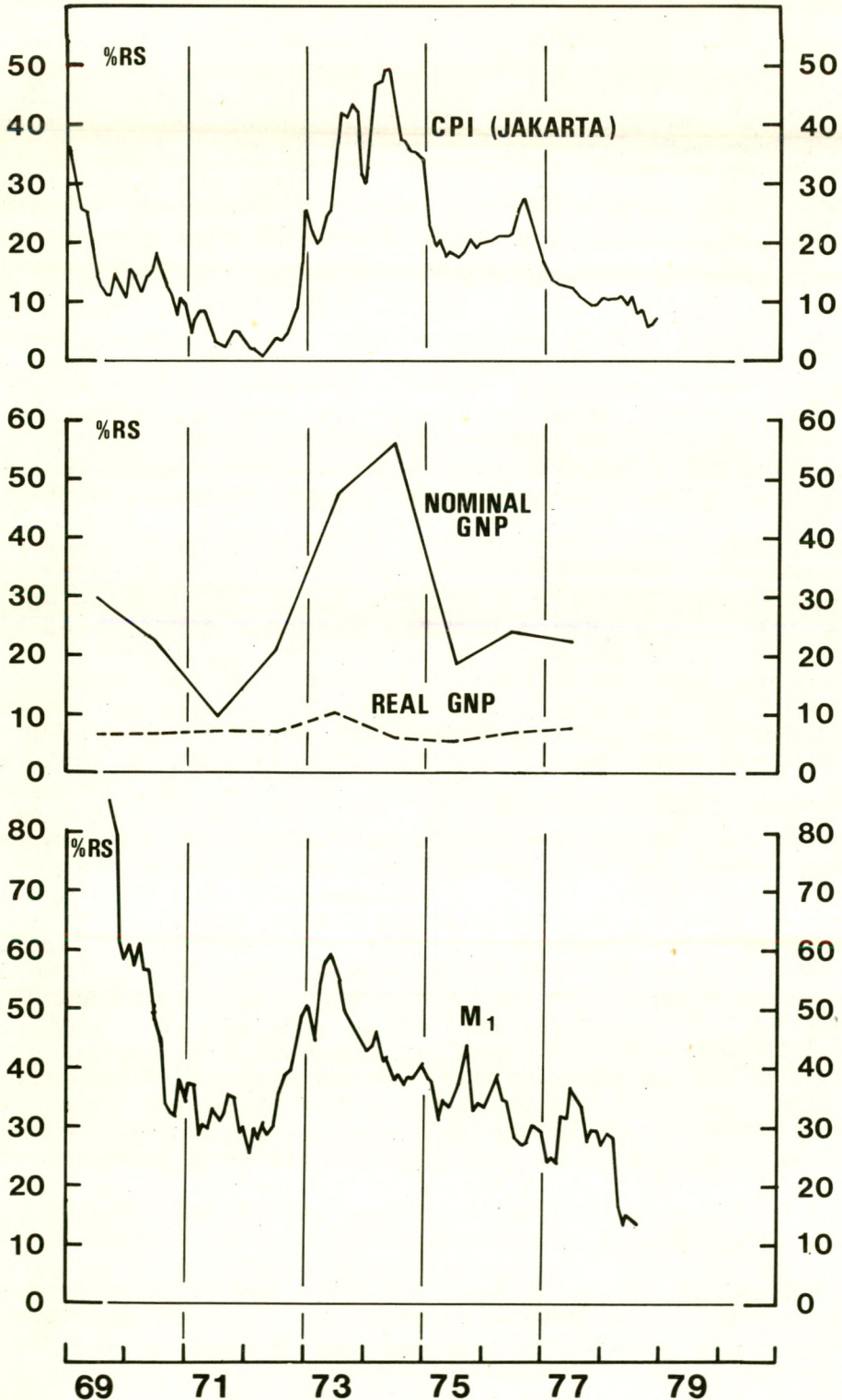
The essential dilemma for the Indonesian government was that the oil bonanza, which came as a *deus ex machina* to put Indonesia on the road to rapid economic development, threatened to stifle the nascent industries which were to spear-head that development. The enormous oil revenues were supporting the balance of payments at an exchange rate which made the traditional industries hopelessly uncompetitive. The inflow of foreign currency generated by the booming oil exports caused a monetary expansion which led to a rate of inflation higher than in any other S.E. Asian country from 1973 to 1976. The resultant escalation of costs for the non-oil industries could not be passed on in final export prices because those prices are by-and-large determined in world commodity markets and the exchange rate was pegged. If the rupiah had depreciated the rubber plantations, palm oil producers and other labour intensive non-extractive industries would not have been squeezed between rising rupiah costs and world dollar commodity prices. As it was, the rupiah did not depreciate because the ample oil revenues easily supported the existing exchange rate.

If such a situation had continued for many years some of the traditional industries would have suffered, and indeed probably already have suffered from long run structural decline, which is difficult to reverse. Yet the development of the non-oil sectors was a matter of urgent priority for the government for two reasons. Firstly, the non-oil sectors employ the majority of Indonesian labour and as such benefit the population more directly than the oil industry and secondly the growth of oil exports was slowing down and in volume terms declined in 1978. The Indonesian economic structure was in danger of being organised around an industry which was already in decline. By 1977 crude petroleum and petroleum products were providing 67% of Indonesian export earnings and the government budget derived over half its revenue from the oil industry. Diversification was an urgent priority, yet it was hampered by the stifling effect of the overvalued rupiah exchange rate.

Even though the balance of payments was relatively robust in 1977 imports were growing rapidly and oil earnings were stagnating. The balance of payments was weaker in 1978 and would have been quite fragile in 1979 and 1980.

Why devalue by 33.6%? In the absence of satisfactory price indices it is difficult to determine whether such a

CHART 1: INDONESIA MONEY, OUTPUT AND PRICES



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devaluation would restore the price competitiveness of the traditional industries. Export prices are no guide as these are determined on world markets and barely reflect the cost pressures which domestic producers have to absorb, so as a rough guide we have instead compared the Cost of Living Index for Jakarta with the Bangkok Consumer Price Index. Both indices are fairly narrow in their sampling and reflect only the prices of items bought by the urban poor. In both capitals the price of rice is regulated and it bulks large in the indices. (The Jakarta Index is based on a consumer survey conducted over twenty years ago!)

After Indonesia devalued her Rupiah in 1971 the authorities must have judged the Rupiah to have been 'correctly' valued. The exchange parity between the Thai Baht and the Indonesian Rupiah remained virtually unchanged until the last quarter of 1978 when Indonesia devalued again, so a direct comparison of the two price indices between June 1972 and June 1978 is justifiable.

Price Index

	A. Jakarta	B. Bangkok	(A)/(B)
June 1972	100	100	1
June 1978	273	191	1.43

Prices in the Indonesian capital rose 43% relative to prices in Bangkok during the period so a 30% devaluation relative to the Baht (and, since they are virtually pegged, relative to the dollar) would restore the purchasing power parity of Indonesia. The actual devaluation was by 34%.

Monetary Policy

After the debauchery of the Sukarno era which culminated in a hyperinflation in 1966, the central bank has been a devout convert to monetary disciplines and it can truly be said that the single most spectacular success of the Suharto government has been the restoration of monetary stability in Indonesia. By 1971 virtual price stability had been restored for the first time in over twenty years. Unfortunately the stability did not last. A serious rice crop failure sent the price of rice soaring in late 1972 and large foreign currency inflows generated a renewed burst of monetary expansion. Consumer price inflation reached over 40% in 1973 and early 1974, but an almost continuous deceleration in monetary growth since then brought inflation down to an annualized rate of around 4% in the first ten months of 1978. (See Chart 1.)

The government achieved this by two main methods. Firstly the government fiscal policy, while nominally declared to aim for a balanced budget, in actual fact has produced surpluses with a contractionary effect on the money supply. Secondly, the central bank has strict control over the credit policies of the state banks which dominate the domestic banking system. The central bank sets both credit ceilings and interest rates.

In the past it has often been the complaint of the banking sector that interest rates have been too high, and Bank Indonesia has been cautious about making reductions. In other words the central bank has had a restrictive bias.

Even though the government introduced a new package of measures to ease monetary policy on January 1, 1978, M_1 growth decelerated sharply in the following months (see Chart 1). The central bank cut the required reserve ratios but bank credit did not expand rapidly, and in November there was still no evident pressure of demand on the credit ceilings imposed by Bank Indonesia. The reduction in interest rates was probably a belated adjustment to the lower inflation rate while the weakening balance of payments reduced the pressure on the monetary base anyway. Chart 2 shows that the net foreign assets of the monetary authorities (the balance of payments component of the monetary base) stopped growing in 1978 and this was the major reason why the base itself slowed down.

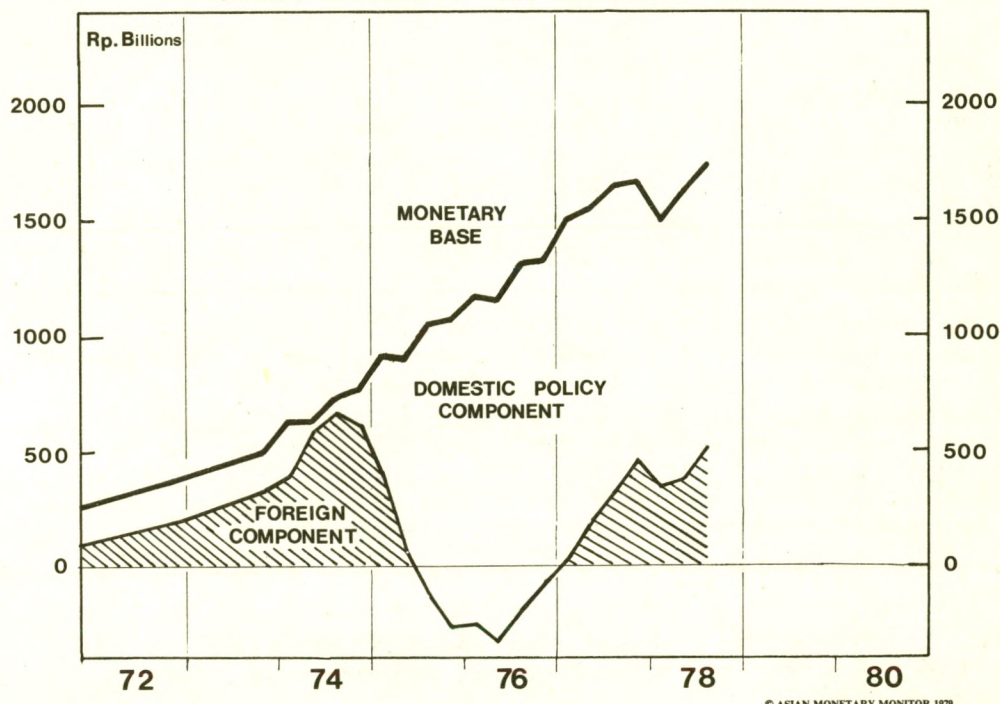
The devaluation therefore came at a time when the Indonesian government had once again restored price stability and low monetary growth with a balance of payments surplus, and as such the devaluation was unusual. Most nations have only considered large devaluations as crisis measures undertaken against a backdrop of chronic domestic inflation and balance of payments problems. To contemplate such action from a position of relative strength would seem to be courting disaster by introducing a major destabilizing factor into an otherwise satisfactory scene. However, the balance of payments surplus was rapidly evaporating. Oil production and exports peaked in late 1977 while non-oil exports in the first half of 1978 were down 6.3% compared with the first half of 1977. If imports were to continue to grow at the rate of the past few years Indonesia's balance of payments would slip into deficit in 1979 or 1980. The devaluation was intended to fore-stall the balance of payments problems which were drawing near.

The Effects of Devaluation

A devaluation strengthens the balance of payments by improving the profitability of the exporting industries while raising the costs of imports. The result is to divert resources to the export industries and away from import-consuming activities. In Indonesia the initial effect will be on the demand for imports rather than export trade because the production of oil and raw materials for export cannot be increased quickly in response to new incentives, while the demand for imports can adjust more easily.

The inflationary effects of the devaluation depend very much on the policy of Bank Indonesia. All things being equal, if monetary growth is maintained at the rate of around 15% per annum which prevailed prior to the devaluation, inflation in the sense of a sustained increase in prices should not be a problem. Once and for all adjustments to prices will take place in the next six months or so as the enormous changes in the relative prices of foreign goods are absorbed. The most

INDONESIA
CHART 2: SOURCES OF THE MONETARY BASE



The effect of the Pertamina Crisis on monetary policy

In October 1974 Pertamina, the national oil company, found itself unable to meet short term foreign debts and the President of Indonesia gave permission to Sutowo the President Director of Pertamina to withhold \$850 million of revenues which should have been paid to the government. A few months later Pertamina failed to refinance 100 million dollars worth of short term foreign debts. In the ensuing furore it was learnt that Pertamina had immediate commitments of \$3.2 billion overseas and \$113 million to domestic contractors. Bank Indonesia hastily stepped in to guarantee all Pertamina's debts and involved itself in a jungle of liabilities.

The emergency financing arrangements played havoc with the Central Bank balance sheet and Bank Indonesia suspended publication of monetary data in May 1975. The overall picture was even worse than that first revealed. Total short term debts of Pertamina were estimated to be \$5 billion and medium and long term debts totalled another \$5.3 billion. Overall Pertamina's debts came to ten times the foreign reserves of Indonesia. By selling off non-oil enterprises and rescheduling payments, the total debt was quickly reduced to about \$6.2 billion, but even so the remaining financing problems were formidable. Of the \$3.8 billion which had to be paid immediately, just under one third was financed by the withholding of tax revenues due to the government. Another two thirds (\$2.5 bn) came from Bank Indonesia which raised the cash by draining its

foreign reserves, drawing on IMF SDR facilities and through a \$1 billion loan syndicated by Morgan Guaranty and the Bank of Tokyo.

The effect on the monetary base is clearly seen in Chart 2. From constituting over 90% of the monetary base, the net foreign asset position of the Central Bank plummeted to a negative figure in 1975. The monetary base was relatively unaffected because the shortfall was made up by an expansion in domestic credit. Bank Indonesia had to meet domestic commitments of Pertamina equal to Rp 600 billion and this additional credit which on its own would have been highly inflationary, instead offset the deflationary effect of the rescue operation.

The overall effect of the Pertamina crisis was therefore probably deflationary, reducing the expansionary pressure of the foreign reserve position on the domestic money supply. Chart 1 shows that during 1975 and 1976 monetary growth continued to decelerate. In 1977 and 1978 the strong balance of payments position rapidly restored the foreign asset position of the Central Bank to pre-crisis levels. The crisis is over, they are publishing monetary statistics again.

difficult problem will be in ensuring that monetary growth is restrained, and recent international developments have a bearing on this.

Since devaluation OPEC have announced that a 14.5% increase in the dollar price of oil will take place during 1979 and political troubles in Iran also threaten to curtail world oil production. Other commodities face tightening markets and commodity prices in general will probably be firm in 1979. For these reasons the outlook for Indonesian export earnings has brightened since last year and had the authorities foreseen this they may not have planned such a large devaluation. They may now be faced with an unanticipated strong balance of payments.

If the authorities have indeed miscalculated and have devalued too much, they will be troubled by large foreign exchange inflows, an acceleration in monetary growth and inflation. As yet there are few signs of this and even some evidence of a perverse reaction: after the devaluation there appears to have been a short speculative run on the Rupiah when time and savings deposits were withdrawn and funds were reportedly invested in the Singapore money markets. These speculative reactions seem to have died down and it remains to be seen how the balance of payments will adjust over the longer run.

As already mentioned, the major weapon the authorities can use to neutralize the expansionary effect of the balance of payments on the money supply is the government budget. Various reported as 'expansionary' and austere' the revised budget for 1979 which plans for a massive 44% increase in expenditure and revenue is not as alarming as it sounds. The increase in government revenue in rupiah terms arises because

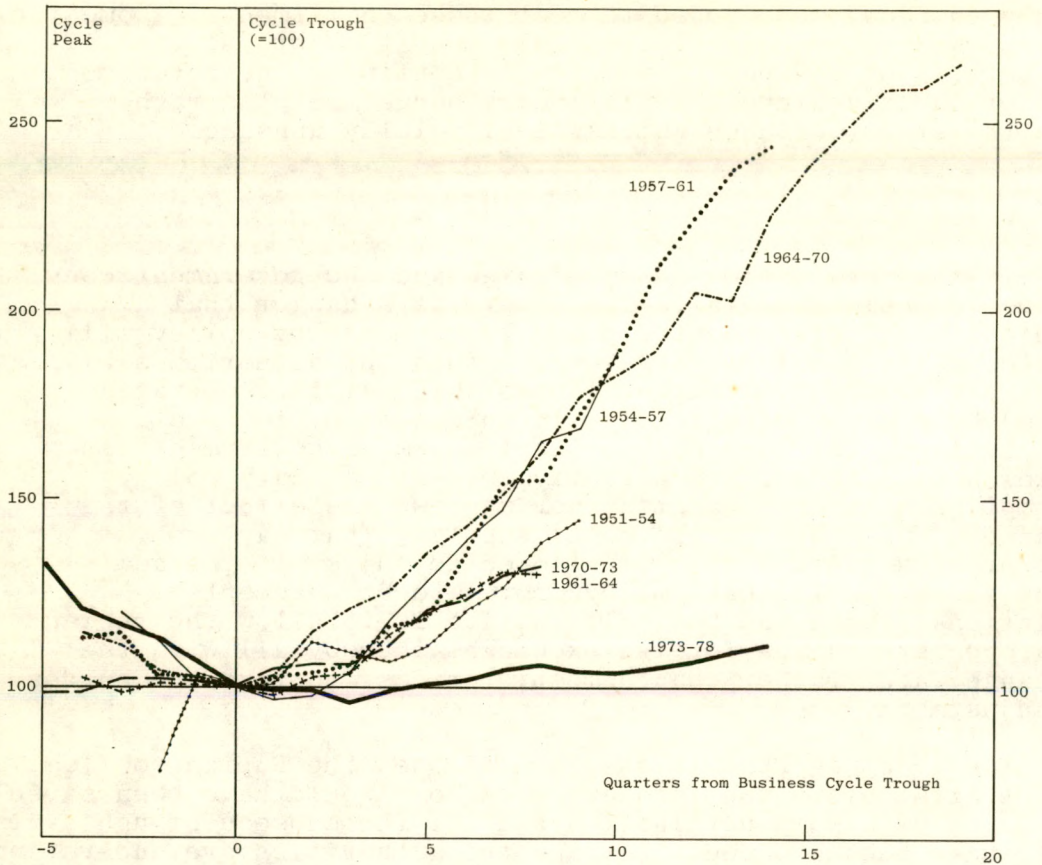
of the tax on oil incomes which are earned in dollars. As the government has substantial foreign currency obligations and expenditure plans, that revenue (which in dollar terms has hardly changed) was needed to meet those commitments. Domestic expenditures have been allowed only modest growth so that if the pattern of the past few years is continued the government will probably achieve a deflationary budget surplus rather than the strict balance which was officially announced.

Conclusion

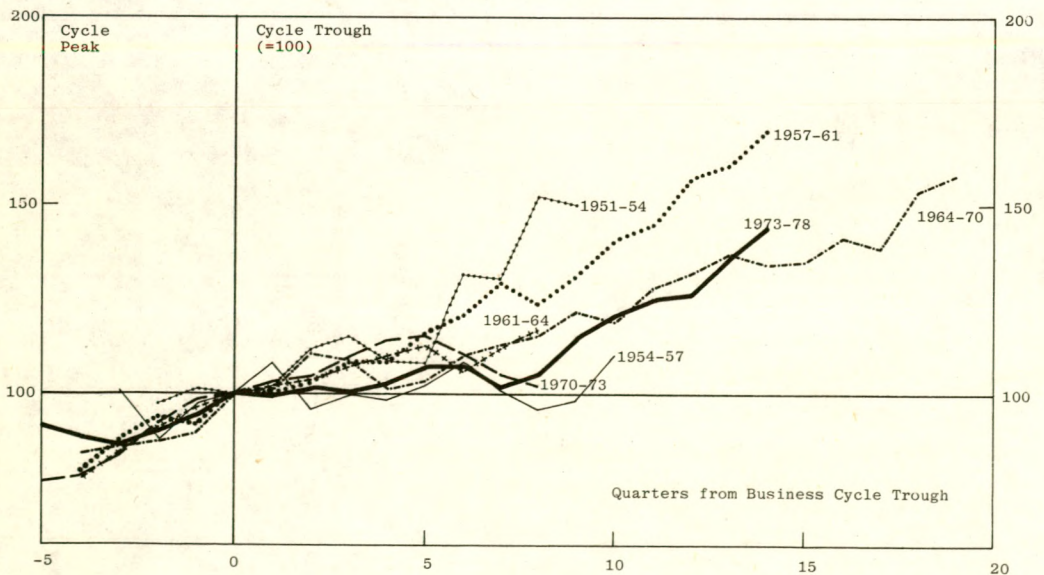
If the devaluation was too large and the government does decide to resist the inflation, there is a danger that a combination of price controls and tight monetary policy will hurt domestic manufacturers because then the authorities will be combating powerful market forces which will be operating to raise the general price level. In such a situation profits will suffer. The best course the Indonesian government can follow now is to adopt a strictly neutral monetary policy attempting neither to augment nor suppress the effect of the balance of payments on the money supply. That way the cost/price structure will be allowed to adjust to the new exchange rate. If that policy proves to be unacceptably inflationary then the best alternative is to allow the rupiah to appreciate on the foreign exchanges thereby allowing the exchange rate, rather than domestic prices, to take the burden of adjustment.

The irony is that if they had allowed the Rupiah to float in the first place the Indonesian economy would have been saved the shock of a jump-devaluation and all the subsequent upheavals could have been avoided. Perhaps the authorities are understandably cautious about free floating exchange rates and it is idle to conjecture how a floating rupiah would have reacted to the Pertamina crisis.

JAPAN: CHART 1
 (A) REAL CORPORATE INVESTMENT EXPENDITURE
 (AT CONSTANT 1970 PRICES)



(B) REAL GOVERNMENT FIXED CAPITAL FORMATION
 (AT CONSTANT 1970 PRICES)



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JAPAN

THE ECONOMICS OF RESTRUCTURING

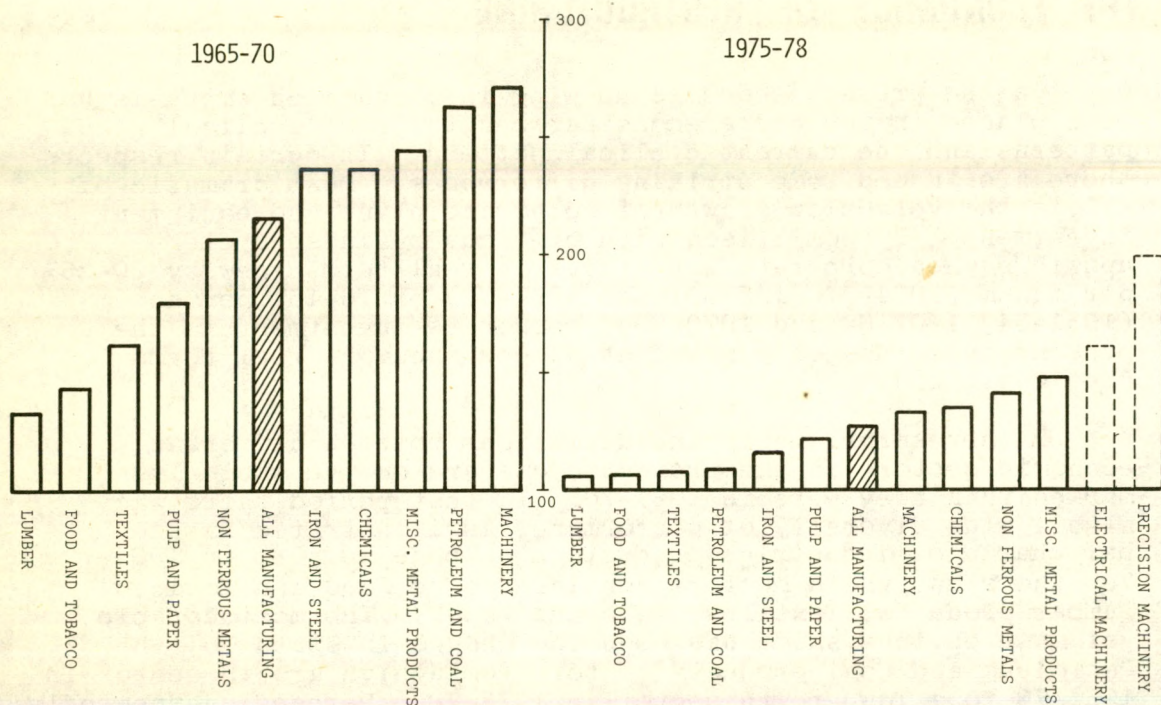
In the present economic upswing in Japan much emphasis has been placed on the differences between the past cyclical patterns and the current cyclical pattern. In certain respects there are indeed some striking differences. Most dramatic of all is the very slow growth of corporate plant and equipment investment. By comparison with previous business cycle upswings when corporate investment in real terms grew by 20-25% per annum (1954-57, 1957-61 and 1964-70) or 10-15% per annum (1951-54, 1961-64 and 1970-73), corporate investment in the present cycle has only grown at 4% per annum in real terms (See Chart 1.)

Rather surprisingly the deviations between different economic sectors in the present cycle are on the whole less marked than they were in 1964-70. In that period there was also a wide diversity of performance as illustrated in the bar charts of industrial production on page 20. As in 1964-70, the slow growth sectors continue to be Food and Tobacco, Lumber products, Textiles, Pulp and Paper. The most notable yet most obvious shift has been the change in status of the Petroleum and Coal products sector from a high growth sector in 1964-70 to a low growth sector in 1973-78. Perhaps unexpectedly Chemicals, Non-ferrous Metals, and Metal Products all continue to be relatively high growth areas in the present cycle. But the most rapidly growing sectors only really emerge when the components of the machinery sector are separated out. For whereas Transport Machinery (which includes Ships and Railway equipment) and Industrial Machinery (mainly machine tools etc.) have underperformed the overall average for manufacturing, Electrical Machinery and Precision Machinery each show significantly greater growth than all other sectors or their components. What economic rationale can be given in explanation of these developments?

The general problem facing Japanese entrepreneurs has been the question of how to reallocate capital and labour to meet the changed pattern of demand since 1973. On the capital side the response of Japanese employers to the reduced profitability of their existing plant and equipment is quite clear from Chart 1(A) - they have responded by a great reluctance to invest in new facilities. The government on the other hand has not been inhibited by the nagging question of profitability which has undermined private investors' incentive to invest. It has therefore pushed ahead pumping relatively more funds into fixed capital formation in the present cycle than in any of the post-war cycles except 1951-54 and 1957-61. (See Chart 1(B).)

But new plant and equipment is not the only variable over which managers have control. They can also vary the amount of labour by regulating overtime and the number of regular hours worked. They can also alter inventory levels, and they can alter output. In differing degrees all of these measures have been used over the present cycle.

CHART 2: JAPAN
INDUSTRIAL OUTPUT GROWTH BY SECTORS



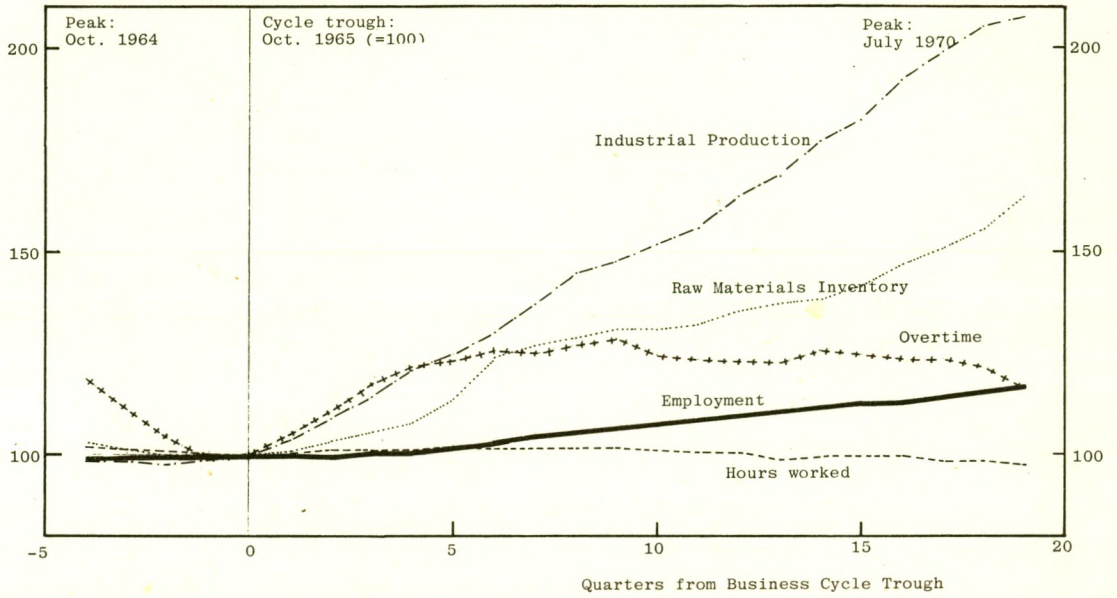
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The easiest item to vary is overtime. Probably because the costs associated with hiring and firing are avoided, employers appear to use this most readily. Thus in both 1964-70 and 1973-78 the decline in overtime was steepest following the peak of the business expansion, and after the trough of business activity the rise in overtime was initially steeper than any other input. (See Chart 3(A) and (B).) However, once overtime has returned to its previous levels it tends to flatten out so that its continuing contribution is limited. In the current recovery overtime has not yet returned to its 1973 level.

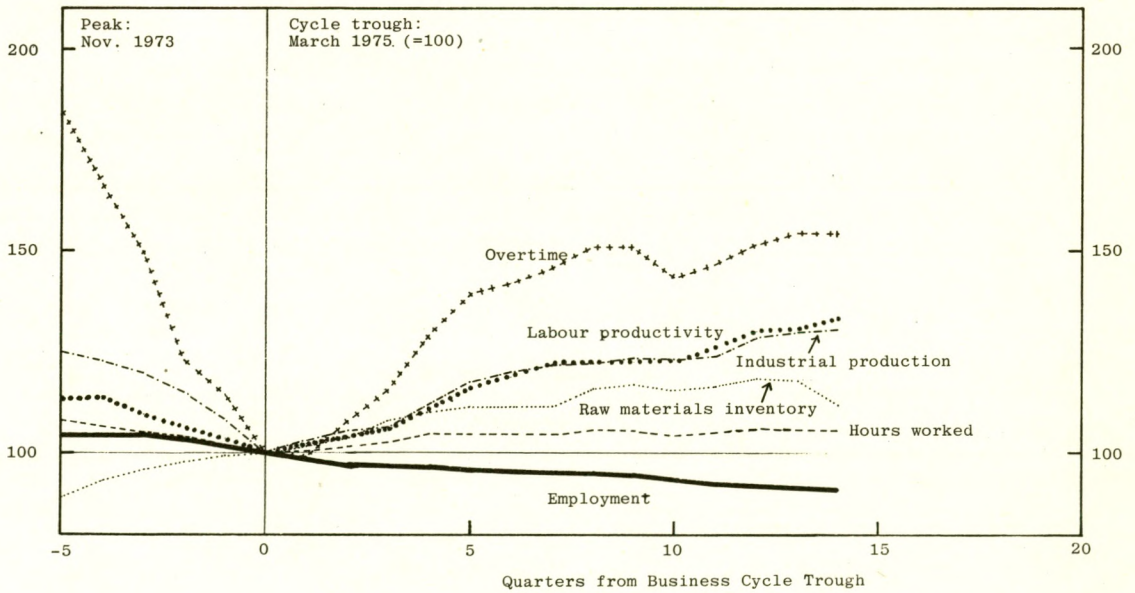
Once a recovery is under way employers can decide whether or not they will need to add to their labour force in order to cope with increased demand in the future. In 1964-70 it is interesting to note that employment in Japan's manufacturing sector rose steadily from about the third or fourth quarter after the expansion had begun. From then onwards employers started to hire employees again and the level of employment grew, but more slowly than industrial production. The difference was made up by higher labour productivity or increased output per manhour. However, in the current 1973-78 cycle employment in manufacturing has been falling consistently since 1973. There has been no move so far to attract additional labour into manufacturing. Initially both working hours per week and employment were reduced in response to lower levels of demand. After the trough, the average number of hours worked has returned to around the 1973 level but employment in manufacturing has continued to fall. Nevertheless, thanks to

JAPAN : CHART 3

(A) PERFORMANCE OF THE MANUFACTURING SECTOR OVER THE CYCLE: 1964-70



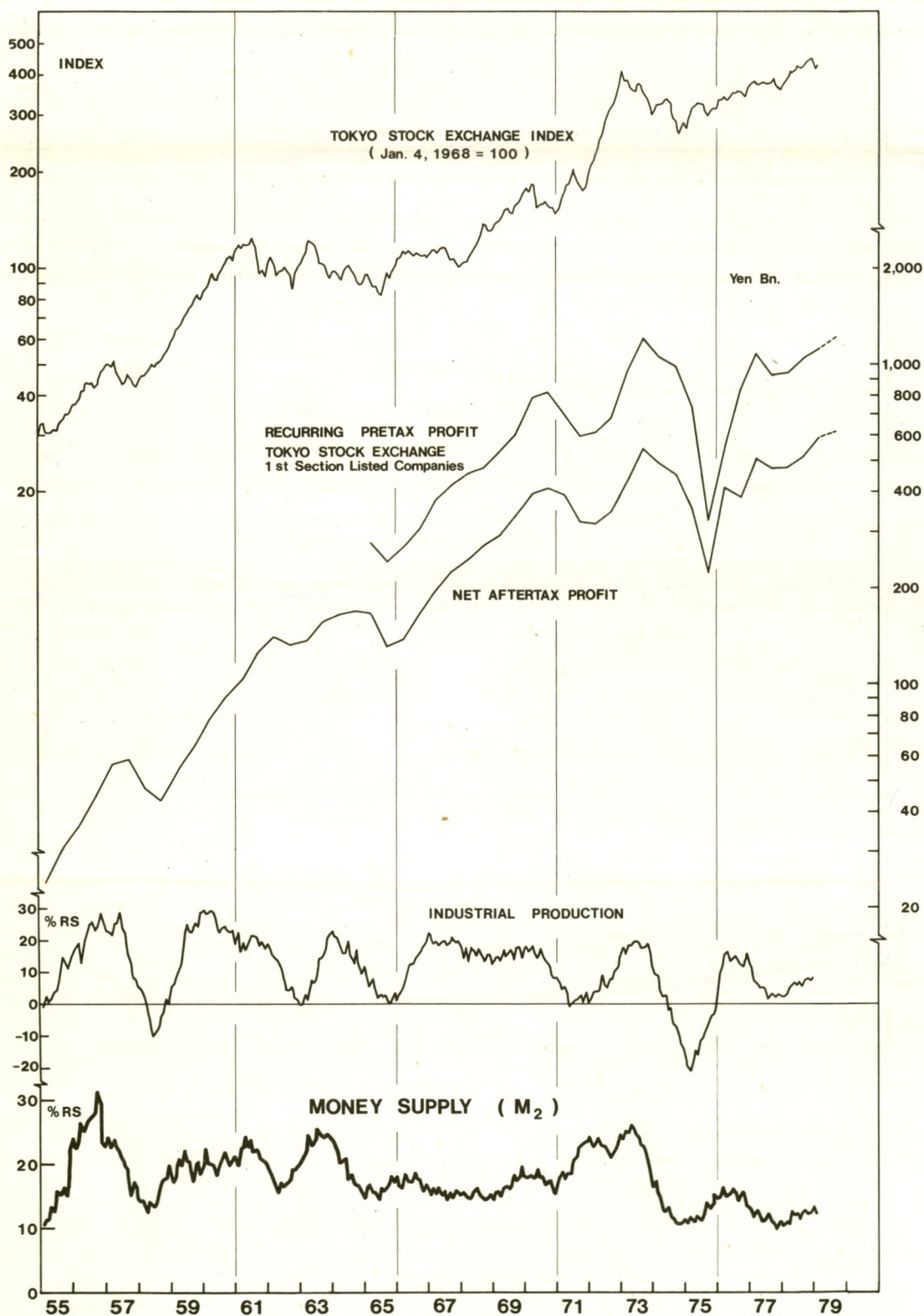
(B) PERFORMANCE OF THE MANUFACTURING SECTOR OVER THE CYCLE: 1973-78



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JAPAN

CHART 4 : MONEY, OUTPUT, PROFITS AND STOCK PRICES



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the rise in labour productivity employers have been able to maintain a modest 6% per annum average growth of industrial output despite the reduced level of employment.

What possibilities are there for a significant recovery in corporate investment in Japan and hence for more rapid economic growth? Firstly, corporations will obviously not invest at the high rates they did in the past until they can expect adequate rates of return. Second, they will not be able to invest unless they can obtain the financing for these undertakings. What then is the current profitability of Japanese industry as a whole, and what rates might be considered necessary to stimulate higher rates of investment?

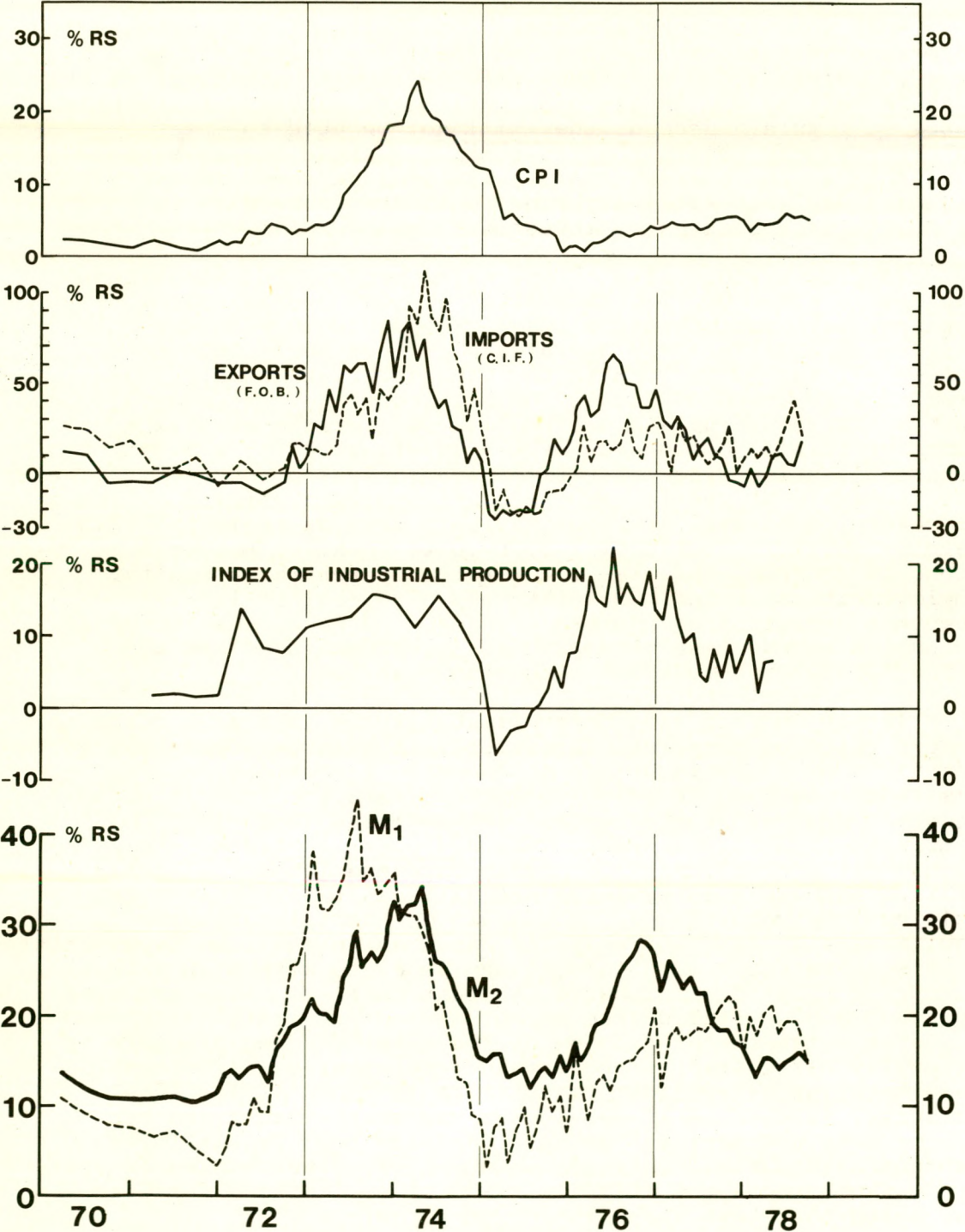
Judging by the ratio of operating profits to sales there has been a steep decline in average overall profitability of Japanese corporations since 1974. Despite some recovery, margins have fallen from 9% in late 1973 or early 1974 to between 4% and 5% in 1978 in the manufacturing industry, and from 6% to between 3% and 4% for all industry. The reason is that while recurring and net profits of listed companies have almost returned to the peak levels experienced in 1973-74 (Chart 4), sales since that time have increased roughly in line with nominal GNP growth. Consequently average margins or rates of return on capital are substantially down on their pre-1973 levels, while the ratio of labour costs to sales has been steadily creeping up. The lower rates of return on capital employed in Japan and the relatively high cost of labour together explain the observed trend for Japanese manufacturing companies to purchase plant and equipment overseas and to expand production overseas rather than at home.

If the current rate of profitability is used as a guide to future rates of corporate investment, it seems evident that no immediate or dramatic upturn in domestic investment is imminent. As long as relative factor costs are lower elsewhere, economic analysis suggests that Japanese manufacturing companies will find overseas land and overseas labour yield higher rates of return. Of course Japanese labour is highly skilled and Japan is well-endowed with capital so that highly skilled jobs requiring large amounts of capital-intensive equipment will tend to remain in Japan while the less sophisticated jobs will be exported. This is why products with high value-added (or knowledge intensive) content or items whose production is capable of a high degree of automation are still being made in Japan while the production of lower value-added products is gradually being transferred abroad. But just as investment in manufacturing or secondary industries in Japan is now less enticing, investment in services or tertiary industries has become more attractive. Because Japanese real income levels are now substantially higher, consumption patterns have changed and consumers can now afford a range of specialised services for which there was very little demand before.

The massive restructuring process now in progress in Japan is not evidence of the Japanese learning the error of their ways and conforming to any pre-determined or desired growth path. It is a multi-faceted response to basic changes in supply and demand conditions in a host of industries, products and markets all over the world.

MALAYSIA

CHART 1 : MONEY, OUTPUT, EXTERNAL TRADE, AND PRICES



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MALAYSIA

THE EXPORT RECOVERY

In 1978 Malaysia followed a narrow course avoiding two extremes. On the one hand the tremendous inflationary stimulus of the 1976 export boom sustained the economy through the following two years, on the other the gradually accelerating level of domestic activity threatened to increase inflation and expand imports at a time when, in the aftermath of the boom, exports were once more sluggish. The government estimates that export volume rose only 3.4% in 1978 compared with a 9% increase in import volume. The consequent weakening of the balance of payments which was already apparent in the decline in the overall balance from a surplus of M\$1,355 m in 1977 to a forecast M\$300 m in 1978 would in due course have led to a tightening of monetary policy and a slowdown in domestic economic activity. Yet this orthodox evolution of the economic cycle now appears unlikely because the deterioration in the balance of payments and monetary tightening have been postponed. The reason is that the export sector has recovered.

After stagnating for nearly two years from mid 1976 the price of rubber (23% of exports) began to rise in March 1978 from under 50 pence per kilo to nearly 65 pence a kilo by November (see Chart 3). Tin (11% of exports) rose from about £6,300 per tonne to £7,800 in the same period. Palm oil (12%) rose from around £300/tonne to £870, and timber (5%) was generally firm. These price rises have helped export earnings catch up with the growth in imports and maintain the strong balance of payments position. Chart 1 shows that the value of exports recovered in the third quarter of 1978 and that import growth remained strong.

The response of the authorities has been a compromise. Earlier in 1978 there was a disagreement between the Ministry of Finance and Bank Negara Malaysia as to whether monetary policy should shift from being 'easy' to moderately restrained in view of the clear evidence that domestic demand was stong. Consumer price inflation was accelerating gradually to over 5% p.a. As indicators of domestic demand the number of new passenger car registrations was up 34% in the first half of 1978 compared with a year earlier and Federal Government sales tax revenue was up 20%. Some degree of restraint in such circumstances would be reasonable, though it could be argued that the damage had already been done in 1976 when M_2 had been allowed to grow 27.7%. M_2 had already slowed to 16.4% by the end of 1977. Despite BNM's desire to curb the excessive liquidity of the banking system, the Ministry of Finance appeared to want to maintain low interest rates in order to encourage private investment which was still sluggish. As a compromise money market rates were allowed to rise but prime lending rate was maintained at 7½% throughout 1978. The excess liquidity ratio (see Chart 2) of the commercial banks declined as credit demand grew (in line with expanding domestic demand)

and the loans/deposit ratio increased from 77.9% in December 1977 to 83.2% at the end of July. Private sector investment expenditure was picking up.

Until the stimulus from the balance of payments was renewed in the second half of 1978, the expansion in the money supply had derived chiefly from domestic factors. The net foreign assets of BNM were virtually unchanged between June 1977 and June 1978 and it was government fiscal operations and growth in the money multiplier which contributed to the overall expansion of the money supply rather than the external sector. Without the stimulus of the balance of payments both monetary aggregates slowed down in 1977 and 1978. By September 1978 M_2 was under 15% up on a year earlier - near to the lower rates of growth of M_2 reached in the recession of 1975. This deceleration in due course would have led to a slowdown in domestic activity with consumer price inflation going no higher than about 6% per annum. Estimating from the long run trend in Marshall k (the ratio of the money supply to nominal GNP) over the period 1963 to 1977 it appears that a rate of growth of M_2 equal to about 12% would allow for a 7% real rate of growth of GNP and a stable price level. A rate of growth of 15% while rather high is not in such a context an alarmingly excessive rate. It appears that the economy has absorbed the monetary expansion of 1976 in a combination of steady growth in real output and moderate inflation over the following two years leaving little scope for further acceleration in inflation.

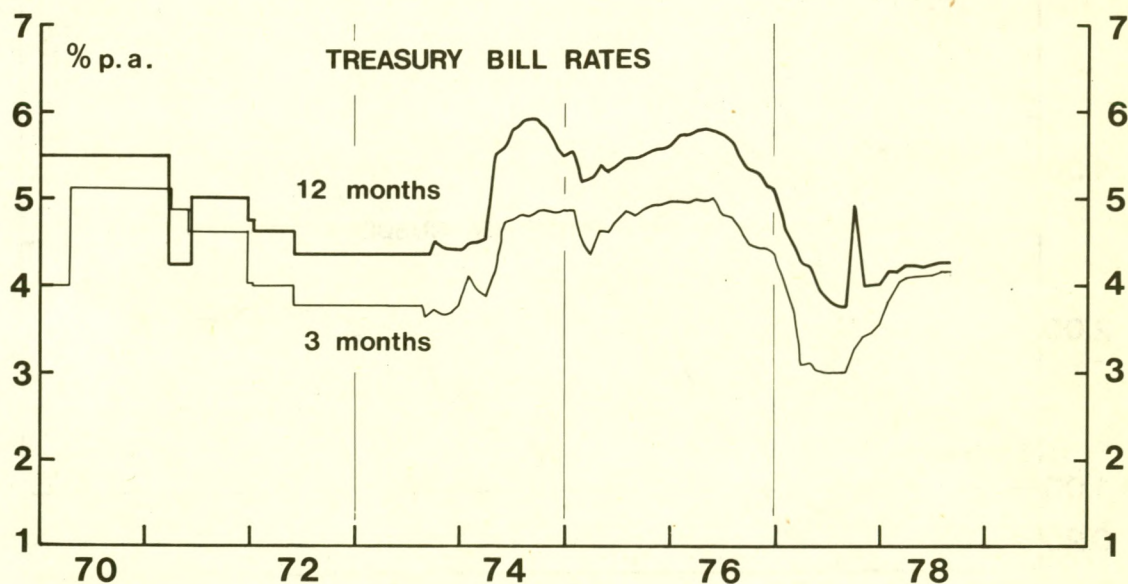
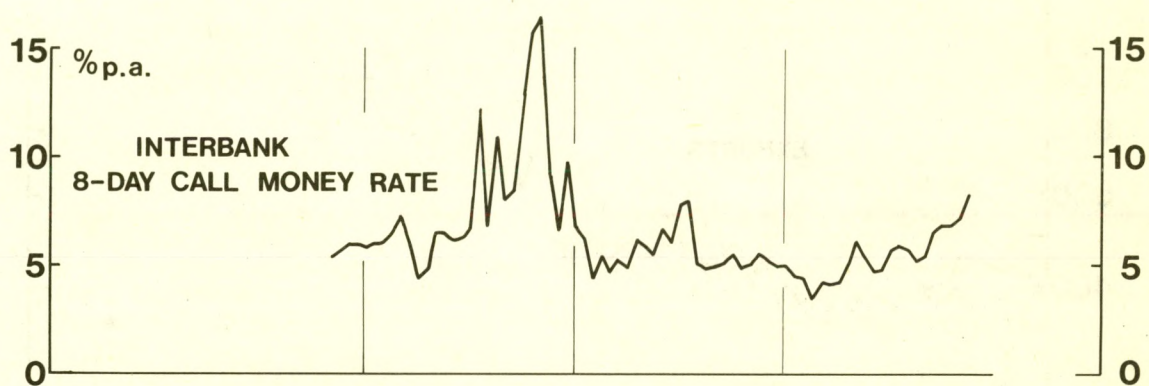
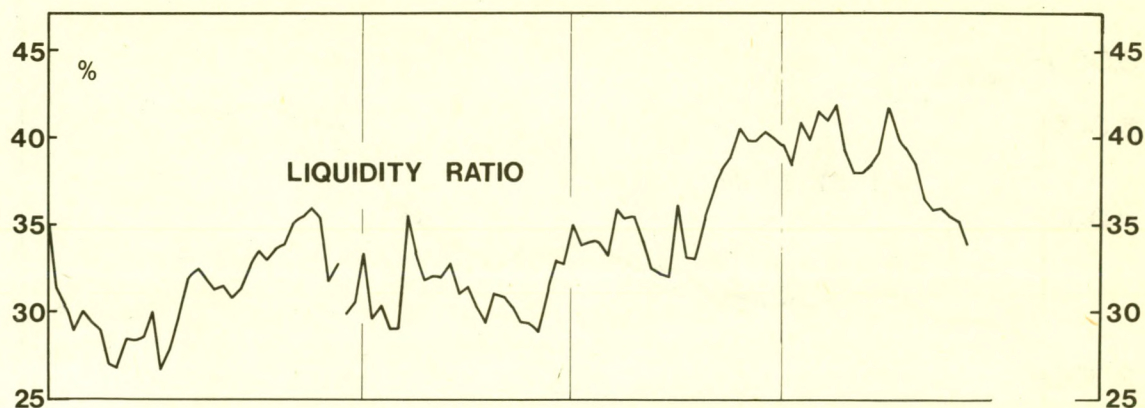
It is extremely difficult to quantify the effect of the upturn in commodity prices on the exports of Malaysia. Although prices may be higher this can be offset by lower volume and frequently is offset in the case of commodities in which Malaysia has a large share of the world market. For instance a drought in Malaysia cut palm oil supplies in early 1978 and the world market price soared. (The export unit value lags the world market price because of the delay in registration of exports, so the total value of palm oil exports in the first half of 1978 was unusually depressed.) Even so the exports earnings certainly recovered in the third quarter and probably in the fourth quarter as well. The net foreign asset position of the monetary authorities began to rise again after June and a reacceleration of monetary growth is likely in view of the relatively passive monetary policy of Bank Negara.

Though there are important special factors affecting the market in each commodity a general macro-economic explanation for a bullish commodity market is not hard to find. By the end of 1978, Britain, Germany and Japan were all enjoying cyclical recoveries in economic activity and the US - near the peak of a business cycle - was booming. When measured in US dollars (or even Ringgits) the aggregate purchasing power of these nations as indicated by their money supplies or GNP figures grew more rapidly in 1978 than in any year since the oil crisis and the tightening commodity markets reflect this.

If, as now seems likely, the US experiences a recession or slowdown towards the end of 1979 the bull market in commodities

MALAYSIA

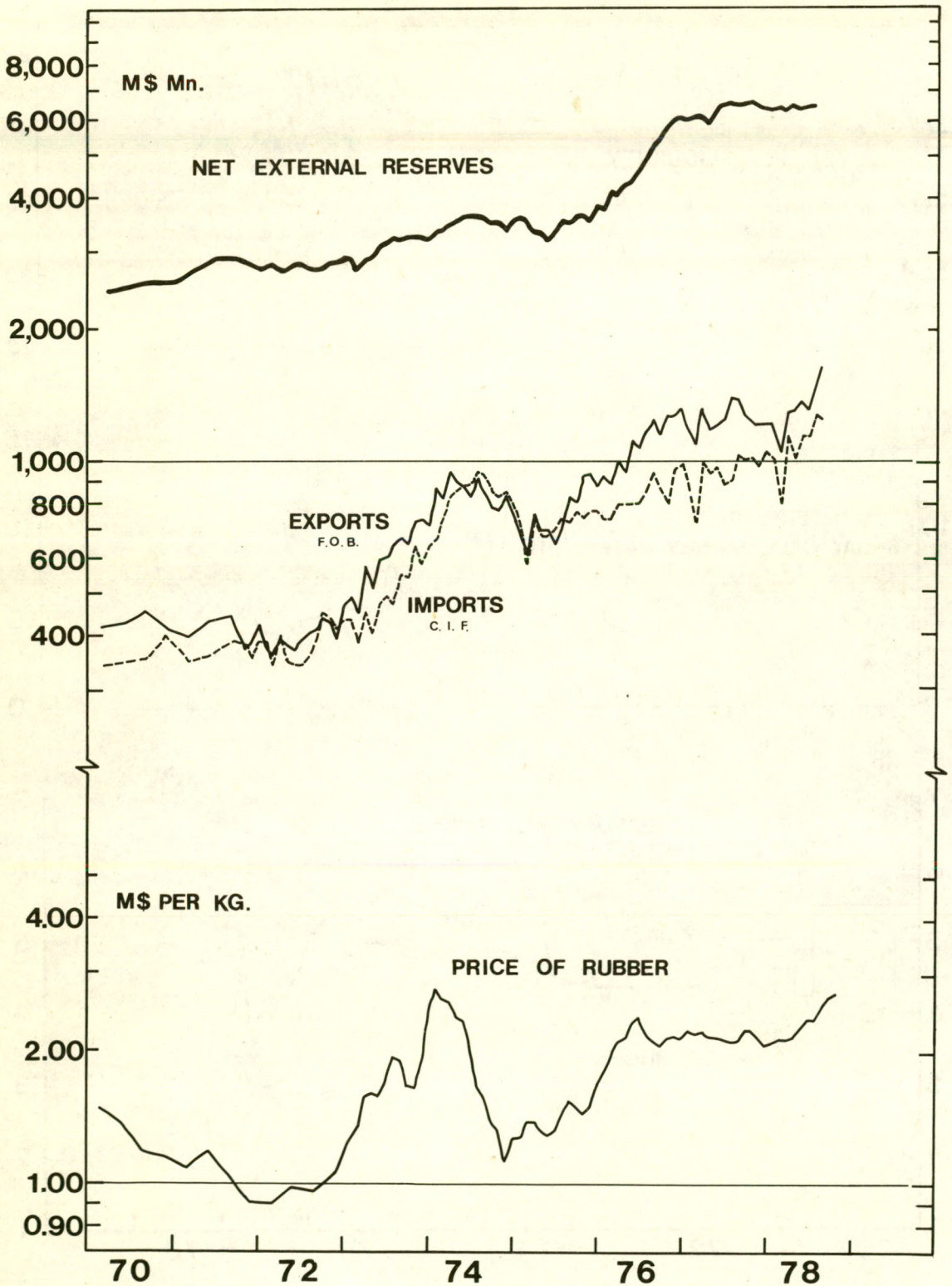
CHART 2 : BANK LIQUIDITY AND INTEREST RATES



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MALAYSIA

CHART 3 : TRADE AND RUBBER PRICE

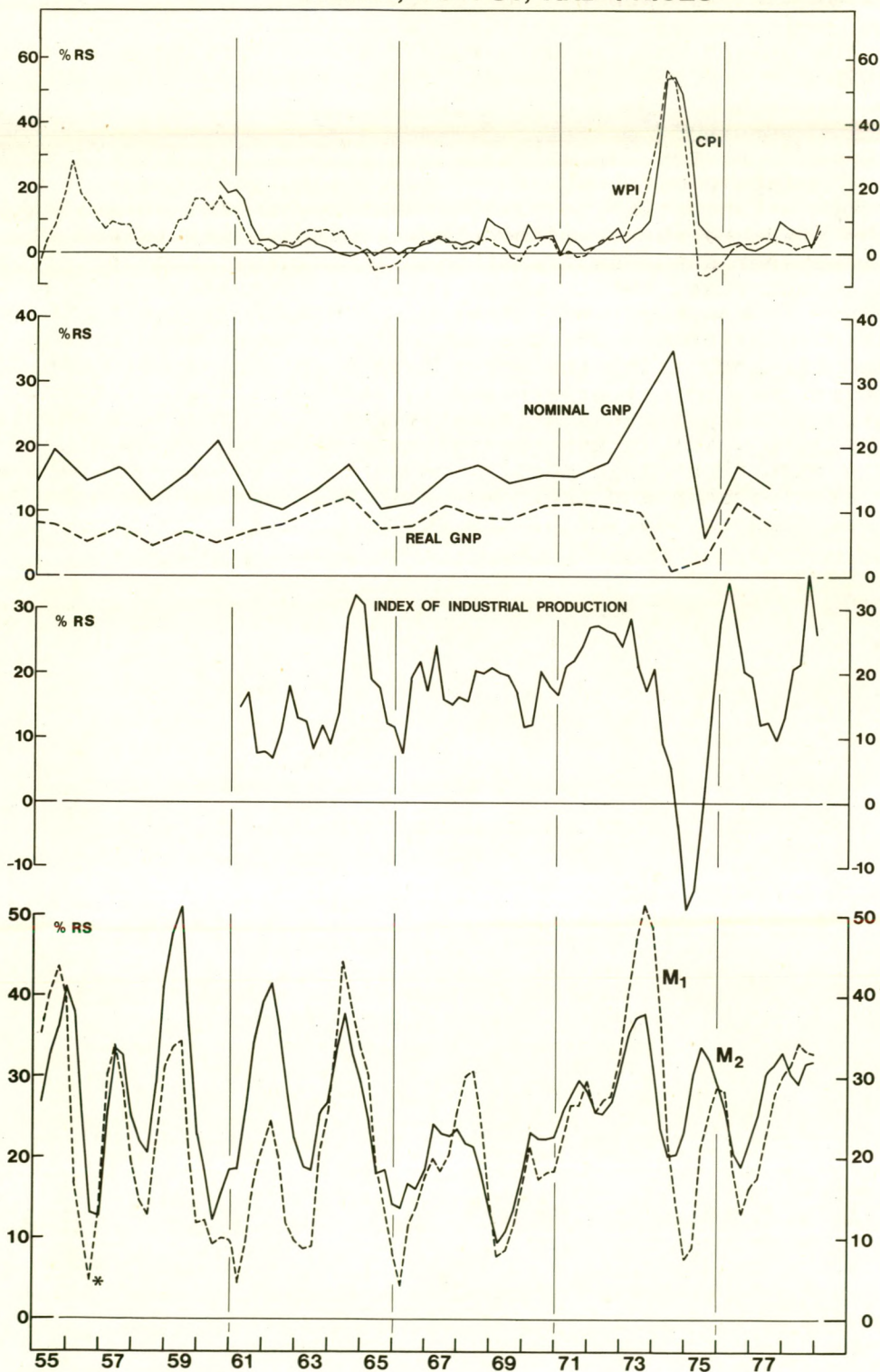


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may not last much longer, but in the meantime Malaysia's export earnings will be strong. The two major export commodities rubber and oil also stand to benefit from the Iran crisis. The price of natural rubber rides on the back of synthetic rubber which, being an oil derivative, is in turn affected by the rise in crude oil prices, so both rubber and oil prices will be firm in 1979.

FORECAST: By the fortuitous intervention of the external sector Malaysia may continue to enjoy a buoyant domestic economy for some time to come without any marked deterioration in the trade balance. If monetary growth is maintained at under 15% per annum an import boom is unlikely and inflation will be moderate, but interest rates will continue to rise in response to growing credit demand. The authorities in their anxiety to stimulate private sector investment may incline to be too lax permitting the money supply to expand more rapidly in which case import growth and inflation will accelerate. The recovery in exports has attenuated the economic cycle enabling Malaysia to maintain her expansionary momentum in 1979 but, unless export earnings really take off, the balance of payments will still weaken and there may well be a current account deficit towards the end of the year.

CHART 1 TAIWAN MONEY, OUTPUT, AND PRICES



* Change of data series.

%RS — Percentage Rate of change over Same period of preceding year.

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A RACE BETWEEN MONEY AND OUTPUT

In our last article on Taiwan in the July-August 1978 issue of AMM we warned that monetary growth might well continue at an excessive rate. The 5.26% revaluation of July 1978 provided no assurance that slower monetary growth would result from the upward revaluation. In the event, monetary growth has indeed continued at an extremely high rate. M_2 has now grown at over 30% p.a. for seven successive quarters. In the fourth quarter of 1978 M_1 rose by 32.8% over its level a year earlier, while M_2 rose by 32.0%. (See Chart 1.) The latest figures available - for December - show growth rates of 34.1% and 32.0% respectively. Compared with appropriate non-inflationary money growth rates of 13% for M_1 and about 17% for M_2 , these growth rates are still too high and surely presage further inflationary pressures at some stage in the not-too-distant future.

What is behind these very high rates of monetary growth? And how is it that they have not already generated double digit inflation?

Growth in the quantity of money can be accounted for (1) by movements in the ratio of the quantity of money to the monetary base, known as the money multiplier, and (2) by growth in the base itself.

$$\text{Money Supply} = \text{Monetary Multiplier} \times \text{Monetary Base}$$

The first part of this article describes the changes that have occurred in the two items on the right hand side of this equation in recent years. The second part of the article describes the changes in the economy associated with the rapid growth of the money supply.

(1) Rearranging the equation above we can write the definition of the monetary multiplier as follows:

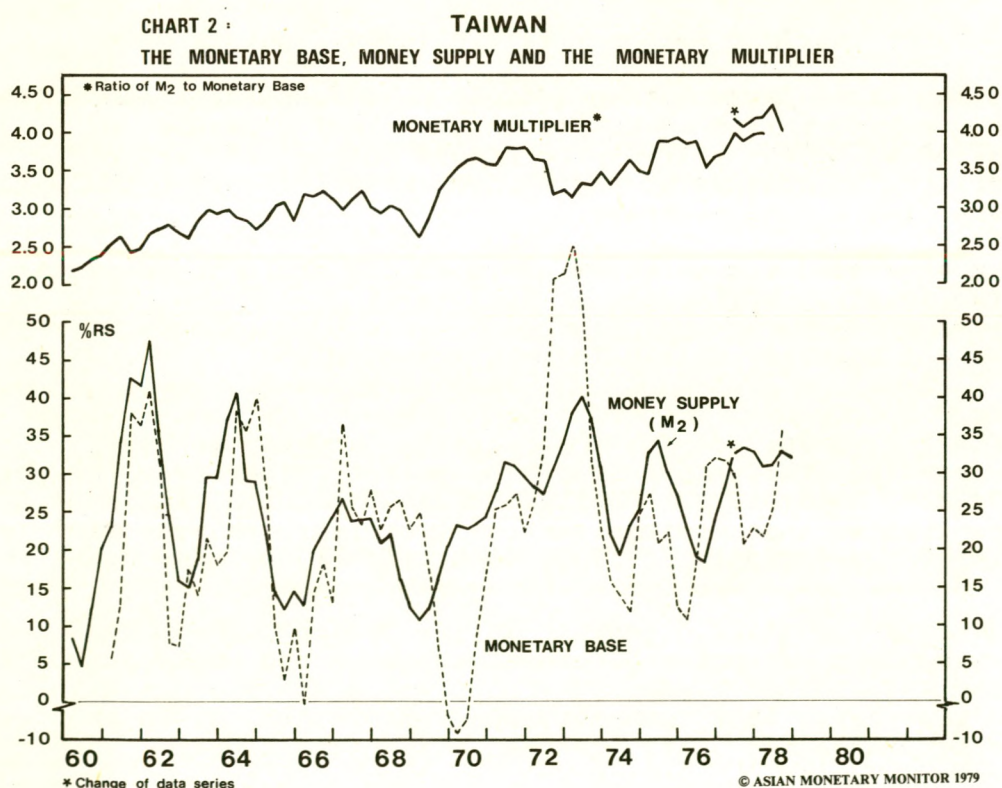
$$\text{Monetary Multiplier} = \frac{\text{Money Supply}}{\text{Monetary Base}}$$

As Chart 2 shows, the money supply (M_2) and the monetary base have generally moved quite closely together over the period 1960-78.* However, the multiplier has been on a rising trend since 1960 so that whereas each unit of the base supported two units of money supply in 1960, each unit of the base now

* The only important exception is the period 1969-70 when there was a sharp but brief divergence between the behaviour of the base and the money supply. Following a sharp decline in the multiplier in 1969, reserve requirements were eased and the multiplier subsequently resumed its upward trend.

supports four units of money supply. This pattern is quite normal in developing countries, reflecting an increase over time in the public's holdings of deposits relative to currency. Apart from the upward trend in the ratio, most of the short-term variations in the multiplier are due either to changes in reserve requirements, or to seasonal shifts in the ratio of deposits to currency held by the public.

(2) From 1965 until 1977 the largest component of the monetary base has been the foreign currency holdings of the Central Bank. Being the sole repository of foreign currency in Taiwan, the Central Bank's holdings of foreign assets expanded whenever the country experienced balance of payments surpluses, as in 1966-67, 1969-71, and 1972-73. The reason was that the Central Bank's commitment to a pegged exchange rate required it to supply domestic currency to absorb the net surplus of foreign currency receipts. The huge surpluses experienced in the early 1970s actually pushed the CBC's (Central Bank of China's) holdings of foreign assets above the size of the monetary base itself. In an effort to restrain the impact on the banking system of an expansion in reserve assets the CBC sharply reduced its loans to commercial banks and in addition the government began to build up a net deposit (= surplus) position at the central bank, thus draining funds away from the private sector. These two shifts in the position of commercial banks and the government, reflected in the downward movement of 'Net Credit to Commercial Banks' and 'Net Claims on Government' in Chart 3, are a classic example of offsetting operations by a central bank.



In attempting to reduce these two items the CBC sought to offset the increase in Foreign Assets, thus preventing the total Monetary Base from rising too rapidly. However, this attempted offsetting was also a classic failure because the money supply grew by leaps and bounds, recording a 59.9% increase in the year to March 1973. In February 1973 the New Taiwan dollar was revalued upwards against the US dollar along with other currencies, but by then the monetary expansion had already been continuing for three full years, so that any restraining effect of the revaluation was overwhelmed by the boom in domestic business activity. When inflated domestic demand and the oil crisis reared their heads together in late 1973 and early 1974 the balance of payments switched to deficit and Foreign Assets dipped sharply, producing a slowdown in the rate of growth of the monetary base and the money supply (Chart 2). On this occasion, to offset the contractionary impact of the fall in foreign reserves the Central Bank substantially increased its net loans to commercial banks. Once again this offsetting operation is clearly shown in Chart 3.

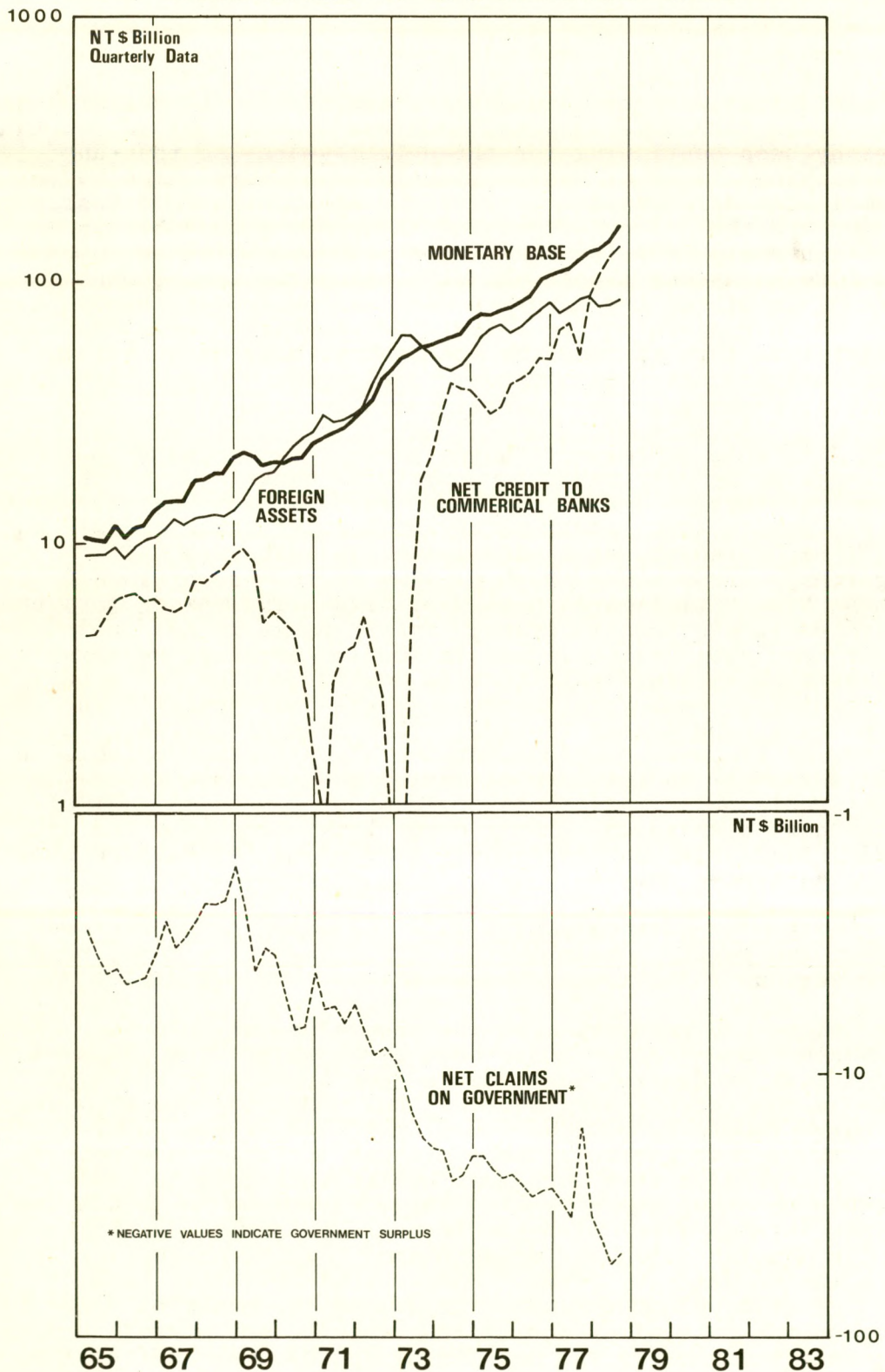
A notable difference in the present cycle has been the role played by Net Credit to Commercial Banks. While the growth of Foreign Assets has been taking a back seat, remaining fairly stable, CBC credit to the Commercial Banks, mainly in the form of rediscounted bank loans, has expanded quite vigorously, from a net NT\$50 billion at the end of 1976 to almost NT\$140 billion in September 1978. The reason for the increase in CBC credits granted to the banks is not entirely clear, but just as a build-up in foreign exchange reserves suggests an exchange rate that is pegged too low, so a build-up in credits to commercial banks suggests that domestic interest rates have been pegged too low. This possibility is given some degree of credence by the existence of extensive controls on interest rates in the form of maximum and minimum rates permissible on certain types of loans or discounts, all of which have been adjusted only eight times since the end of 1974. Similarly, on the deposit side of banks' balance sheets there have been only seven such rate changes.

Given the extremely high rates of monetary growth over almost two years, how is it that there has not already been more serious inflationary pressure?

Since the recovery from the deep slump of 1974-75, Taiwan's economic growth has been formidable. The index of industrial production has increased on average by 20.7% per year in the three years 1976-78. Real GNP, the widest measure of current output, has increased by 10.9% per year over the same three year period. The fact that inflation has not yet really increased very much must be attributed in no small measure to these exceptionally large increases in industrial output. In parallel with the increase in output, real incomes in the manufacturing sector have grown almost proportionately with the quantity of money. However, since Taiwan is still at a stage of development where the demand for money balances exceeds the rate of growth of real income, the overall build-up of money balances by the manufacturing and non-manufacturing

CHART 3 : TAIWAN

COMPONENTS OF THE MONETARY BASE



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sectors together is substantially in excess of their combined average real income growth. Thus even if there has been growth in the money supply in excess of real output growth this need not show up as inflation. The problem is to determine how much monetary growth is required as an addition to cash balances.

Based on a per capita real growth rate of 8% per year we previously estimated an appropriate, non-inflationary rate of monetary growth for M_2 to be in the region of 17% per year (AMM Vol. 2 No. 4). In 1978 real GNP growth was actually close to 13% which suggests that M_2 growth of up to 22% would not have been over-indulgent. However, unless that 13% growth is sustainable, the economy would have been better served by a slower rate of growth in 1978. Nevertheless, one must admit the possibility - especially given the record of Japan's remarkable growth rates in the mid-1960s - that maintenance of such high rates of real growth is not inconceivable. Considering Taiwan's labour force is growing at 3.4% per year, and according to official statistics 34% of the population was under 15 in 1977, the labour force is likely to continue to grow at a rapid pace for several more years. Another piece of evidence which also suggests a sharp increase in Taiwan's productive capacity is the fact that in 1978 the trade balance remained firmly in surplus. Therefore a temporary period of 20-25% M_2 growth could be compatible with quite modest rates of inflation. However, monetary growth rates of 30-35% such as the economy has experienced in the past two years will probably lead in time to inflation rates in the range 10-20%. To date the excess has mostly been absorbed by higher output and increased holdings of cash balances, so that the inflation rate has not yet risen above 8-9%. However, if the government forecast of 8% real GNP growth in 1979 turns out to be correct, it is likely that inflationary pressures will intensify in the year ahead.

BOOK REVIEW

THE INDONESIAN ECONOMY SINCE 1965

A Case Study of Political Economy

by Ingrid Palmer. Frank Cass & Co. Ltd. London, 1978.

If the purpose of economic development is to increase Gross National Product then few would argue that the strategy adopted by President Suharto's regime has been successful. The massive investment schemes using foreign capital have enabled Indonesia to exploit the natural resources that lie in her outer islands. The government budget and the balance of payments now depend heavily on oil revenues, and timber from the great forests of Sumatra and Kalimantan generates more foreign exchange than the traditional rubber industry. The steelworks at Krakatau, the Jatibarang fertiliser plant and other large industrial projects give further testimony to the effort and resources that have been committed to the economic growth of Indonesia.

Has the effort been worthwhile? In an economy where capital is scarce, is it being allocated in the sectors where it can generate the most social benefit? Have indigenous enterprises or the poverty-stricken rural masses of Central Java benefitted from the tremendous increase in capital investment in the past ten years? In an excellent review of the economy of Indonesia in the decade after the fall of Sukarno, Dr. Palmer questions the overall thrust of government policy. Throughout the book she draws a distinction between 'endogenous' and 'exogenous' economic activity. Endogenous development has strong income generating multipliers, which provide many jobs for the local population and increase the demand for the produce of Indonesian labour. Exogenous development in contrast is typically capital intensive, requiring imports of foreign capital and skilled labour and it creates relatively few jobs for the indigenous population.

Dr. Palmer's distinction between exogenous and endogenous development is somewhat imprecisely drawn. 'Income generating multipliers' are not particularly helpful in discussing the issues involved. A new project can affect the native Indonesian in only three ways: firstly it can increase the demand for labour (i.e. bid up the real wage), secondly it can reduce the real cost of goods and services purchased by Indonesians, or thirdly it can earn foreign income which is transferred via government tax and benefit schemes into the pockets of Indonesians by grants or subsidies. Dr. Palmer does indeed discuss the first factor, the demand for labour and this is the basis of her exogenous/endogenous distinction. She comes to the conclusion that the development strategy certainly has not achieved very much in this respect considering the enormous amount of expenditure involved. The second factor is hardly discussed at all; if the demand for labour is increased only by erecting import barriers and providing goods at a higher price than would otherwise be the case, the net effect on aggregate real income is even less. Finally, in a nation which produces a minimal surplus above the subsistence requirements of the population, exploitation of resources in the exogenous sector

may be the easiest way to increase the surplus which can then be transferred to development projects in the endogenous sector.

The implication of the development strategy should be discussed with regard to all three of these considerations but Dr. Palmer's analysis is somewhat partial, placing emphasis mainly on the demand for labour. However, leaving that aside, Dr. Palmer's study of the record of progress in each industry shows that a major part of the investment expenditure in the first decade of the Suharto regime went into exogenous development, building up the extractive oil and timber industries and creating a modern sector largely irrelevant to the lives of the vast majority of Indonesians. Endogenous industries have in comparison lost out in the competition for resources. The traditional export crops were slow to recover and received low priority in the early post-Sukarno years. Manufacturing production, especially of textiles was badly hit by both foreign competition and the tight credit policy.

Whereas poverty is the problem of low productivity of people, the Indonesian development strategy has addressed itself to a different task. It has striven to increase the income generated on Indonesian territory: "a cursory look at the economic and demographic maps of Indonesia published in the early sixties shows that the new exogenous economy is generally outside Java and outside the centres of population and need for employment in the outer islands. The oil and timber industries have as much immediate bearing on the mass-based Indonesian economy as has the Hawaiian tourists industry - possibly even less since once at Hawaii tourists may go on to Bali and Java."

Dr. Palmer's criticisms are justified but she tends to understate the positive factors. No one would deny that much of the foreign capital has been invested inefficiently - as has been revealed by the Pertamina debacle - but the government of Indonesia has come increasingly to recognise the shortcomings in its development policy. The Third Plan places more emphasis on reducing the income disparities and gives greater attention to the endogenous economy; these are problems which, as the author admits, are more intractable than the relatively easy task of exploiting natural resources. Nevertheless some progress has been made and perhaps the stumbling block is now not so much the lack of good intentions but the corruption, inefficiency and bureaucracy which permeate all areas of public administration. There have been honest and even successful attempts to improve agricultural productivity.

The criticisms of the 'New Order' economic policies have been heard in government and private circles before, but Dr. Palmer's book provides a readable well-argued case and more-over a great deal of information which is valuable for anyone who is interested in this period of Indonesian development. Although the book was first published in 1978 it really only covers the period up to about 1975 so the Second Five Year Plan (1974-9) is outlined only briefly. Despite the Subtitle, 'A case study in political economy', the treatment of the material is essentially from an economic standpoint; social and political developments are not the subject of this book.



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THAILAND: Deliberately Tightening Up.

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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

REGIONAL SURVEY

EXCHANGE RATE POLICY AND STOCK MARKET BEHAVIOUR

Since the early 1970s the monetary authorities of the world have generally moved in one of two directions. Either they have moved in the direction of controlling their domestic money supply and allowing the exchange rate of their currency a greater degree of flexibility than in the past, or they have moved in the opposite direction pegging their exchange rate more or less rigidly to a single currency (such as the US dollar) or to a mixed basket of currencies. The two polar extremes to be kept in mind are therefore:

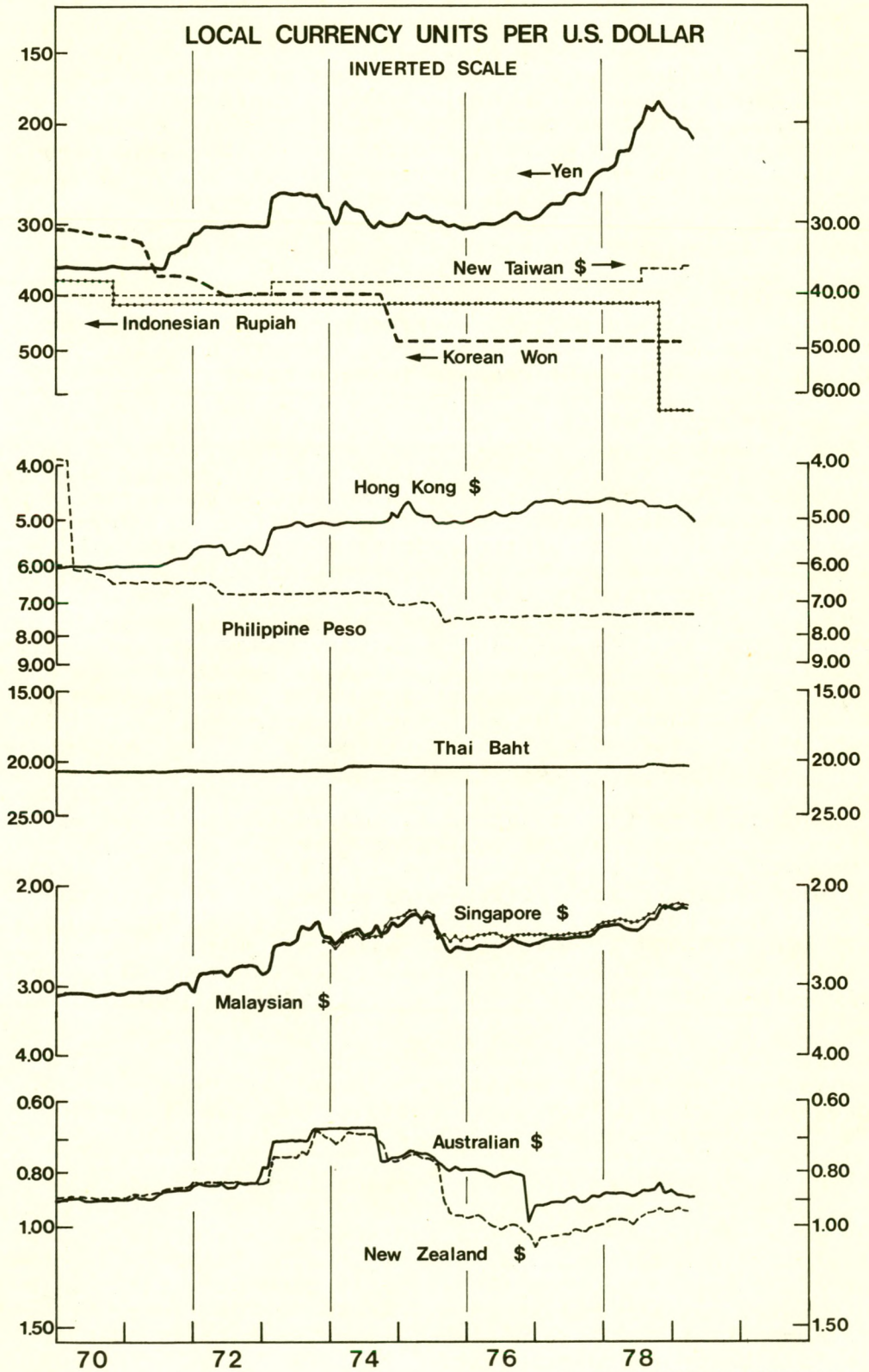
- (1) controlling the money supply and allowing the exchange rate to float, and
- (2) pegging the exchange rate and allowing the money supply to adjust to whatever is necessary to balance the country's international payments.

Now in practice few countries rigidly pursue either policy to its limits, but nevertheless the principle is valid, and these two polar alternatives serve to provide a useful scheme for classification.

Applying this classification to the more important currencies of Asia, the Japanese yen is the only currency which clearly falls into the first category i.e. a currency where the money supply has been controlled and the exchange rate has, by and large, been allowed to float. Starting in July 1974 the Bank of Japan began to announce monetary growth targets, and by the end of the same year it was starting to show remarkable success in achieving those targets. At the same time the attempt to peg the yen permanently at any fixed value in relation to the US dollar was abandoned, though from time to time the Bank of Japan still intervenes temporarily to peg the yen's upward or downward movement. But the important point is that whenever it does intervene it also takes action to offset the impact of its purchases or sales of foreign exchange on the domestic money supply. In other words, the money supply target has become the most important priority of Japanese monetary policy.

Examples of monetary authorities which have moved in the opposite direction - either pegging their exchange rate or arranging for it to move against a mixed basket of foreign currencies - are numerous. In Chart 1, the New Taiwan dollar, the Korean won, the Indonesian Rupiah, the Philippine peso, and the Thai Baht, the Singapore dollar and the Malaysian Ringitt are all currencies which have generally been managed in this fashion. The logical consequence of this policy is that these countries are not free to determine their domestic money supply growth. The money supply must be whatever is necessary to balance the country's international balance of payments.

CHART 1 EXCHANGE RATES IN THE FAR EAST



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However, because it has become fashionable to announce monetary growth targets, several countries prefer to ignore this logic and, despite pegging their currencies, they also purport to pursue monetary growth targets. Australia is a good example of a country where this confusion prevails: the currency is managed in a composite float and yet the Treasury and the Reserve Bank make public announcements specifying a money supply growth target. Predictably they have recently overshot their target by such a margin that they have been forced to abandon it. It is therefore realistic to classify Australia as a country which pays only lip service to controlling the money supply and in practice pays more attention to pegging the external value of the currency.

The only clear cases - apart from Japan - where this confusion between pegging the currency and controlling the money supply does not exist are Singapore and Hong Kong, but for completely different reasons in each case.

In Singapore it is recognised by the Monetary Authority of Singapore that either the currency's external value can be managed, or the domestic money supply must be managed i.e. one cannot do both. The MAS has chosen to manage the currency in the foreign exchange market according to a (secret) formula based on the structure of the country's trade. Accordingly and logically, no money supply target is announced. This is deliberate. But it does not mean that monetary growth has been unrestrained: the money supply has grown at only 11 pct. over the past year (a rate which is very modest compared with the real growth potential of the economy) and the CPI is up just 3 pct. year-to-year. Malaysia, which tries to keep its currency very much in line with the Singapore dollar has done slightly less well, but the authorities in both countries are to be credited on their excellent results.

In Hong Kong the situation is very different. As implied earlier, it is possible to control either the money supply or the exchange rate, but not both. Curiously, in the 1970s when most monetary authorities were doing one or the other, the Hong Kong authorities did neither. In fact, Hong Kong since 1974 has had a floating exchange rate and a money supply which is not controlled. As a result the currency has recently been falling and the inflation rate is accelerating.

* * * *

In considering the relation between stock market action and exchange rate policy it is useful to divide the period 1970-79 into two segments: 1970-74 and 1975-79.

During the first of these periods there is a notable similarity in the direction of stock market movements. Japan, Hong Kong, Singapore, Malaysia and Australia and New Zealand all experienced the same pattern of upswing in 1972-73. (See Chart 2.) The only exceptions to this general pattern were South Korea and the Philippines. In Korea the index movements were more erratic and volatile, falling especially sharply in late 1971 before recovering again in 1972. In the case of

Philippines the indices continued downwards until late 1972, and turned upwards sharply in 1973, long after most other stock markets.

It is interesting to note that whereas Japan, Hong Kong, Singapore, Australia and New Zealand all had fixed exchange rates up until 1971 and thereafter gradually revalued their currencies against US\$ (see Chart 1), the two exceptions, Korea and the Philippines, both had depreciating currencies until early 1972. In the case of the first group of countries the pegged exchange rate initially produced growing balance of payments surpluses which were later replaced by deficits. For most of these countries balance of payments surpluses generated expansionary monetary growth which fuelled a stock market boom, and conversely when deficits took over monetary growth decelerated and the stock market declined.

In 1974 all Far East countries without exception experienced sharply declining stock markets. In the case of those countries with pegged exchange rates this was associated with deteriorating balance of payments deficits and a tightening domestic monetary climate. For some countries like Japan, the Philippines, Singapore/Malaysia and Australia/New Zealand the deterioration in the balance of payments was mitigated by allowing the currency to depreciate.

The recovery in stock market values after 1975 and the general pattern of movement of stock market indices can also be related to the effects of exchange rate policies on the domestic money markets. In general terms one can say that whereas Japan has been able to pursue a quite stable monetary policy, thanks to its floating exchange rate, most other economies of the East Asian region have, as a result of their policies of pegging the currencies to the US dollar, experienced unstable monetary growth. The pegged exchange rate policies have generally been a destabilising influence on the domestic economies, transmitting monetary instability from the USA to other economies. Some of the evidence for this proposition can be seen in Chart 2.

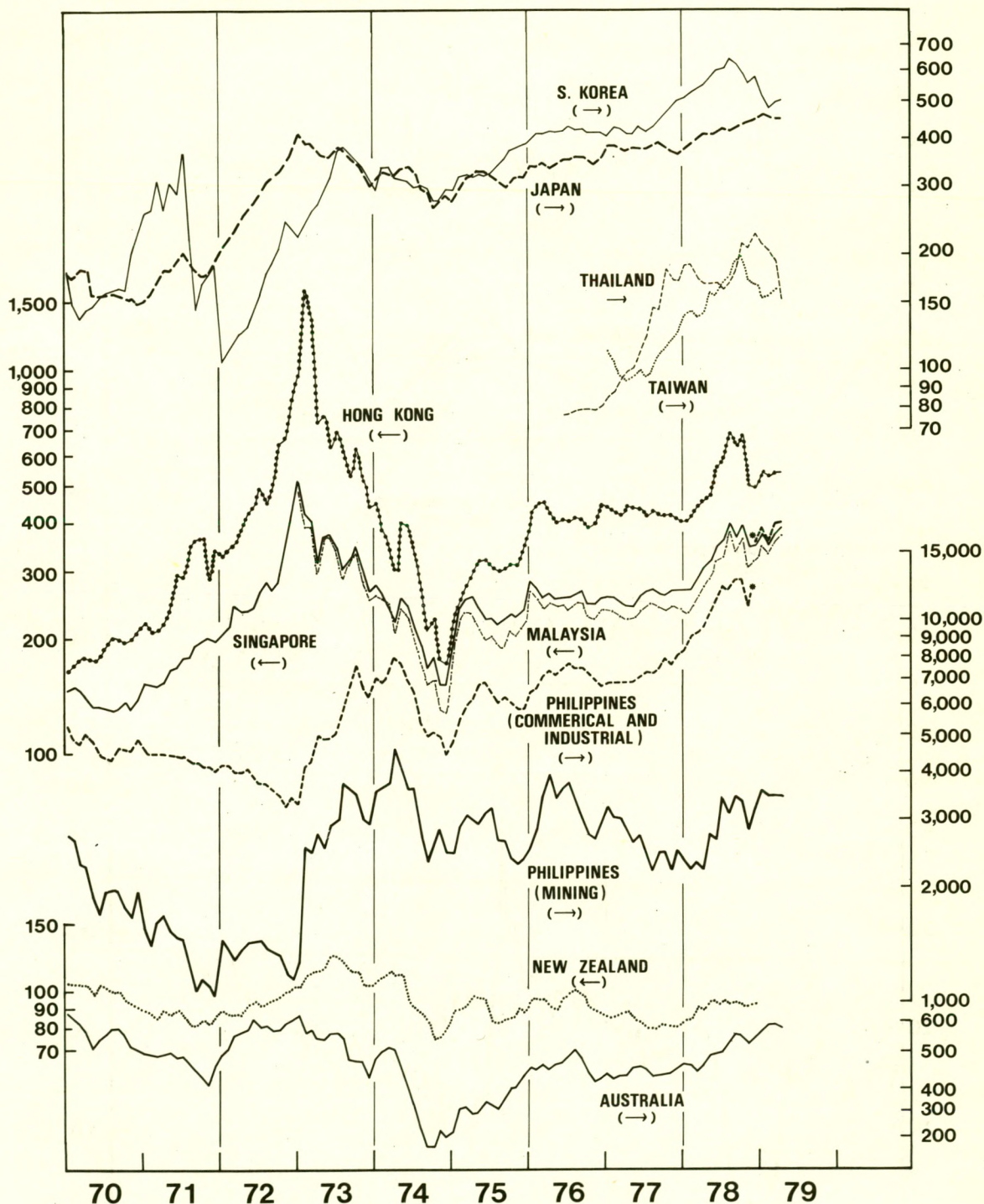
The Japanese stock market has been the most stable in the region over the past 4 years since the switch in exchange rate policy. The stock markets of Korea, Taiwan, Thailand and the Philippines - all essentially pegged exchange rate economies - have to a greater or lesser extent displayed roller-coaster characteristics. In 1977-78 they moved up strongly on the apron strings of the boom in the US economy, thanks to the acceleration of the money supplies in each country following on the improvement in their balance of payments positions. Subsequently they have turned down - with the exception, perhaps, of the Philippine mining index - as their respective balance of payments positions have deteriorated and monetary growth in each country has tightened.

The stock markets of Singapore and Malaysia together with Australia and New Zealand - all countries which have had

essentially managed exchange rates - have shown less volatility since 1975 than the pegged exchange rate group, but they have not been as steady as the Japanese index.

Finally, the Hong Kong stock market since 1975 has been something of a law unto itself, rising further and more steeply than all others in the first nine months of 1978, and then collapsing very sharply in October and November. But given that it has had the most unusual monetary policy, perhaps it is not surprising that its stock market behaviour has also been highly unusual.....

CHART 2 FAR EAST STOCK PRICE INDICES

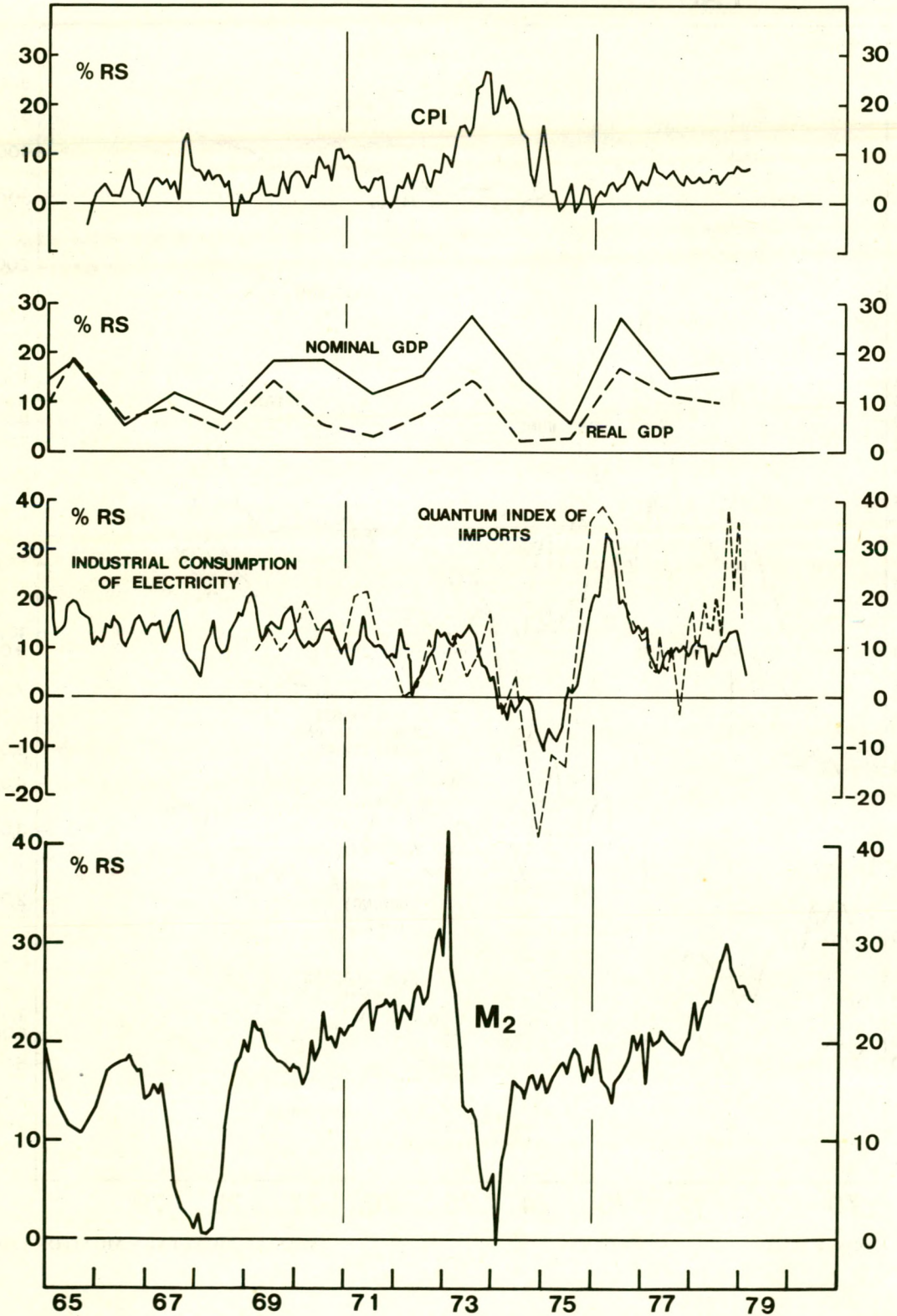


* Change of basis of compilation on 4/12/78

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HONG KONG

CHART 1 : MONEY, OUTPUT INDICATORS, AND PRICES



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HONG KONG

PROPOSALS FOR A REFORM OF THE MONETARY SYSTEM

In seeking to stabilise the value of the Hong Kong dollar and to reduce inflation in Hong Kong, the Government faces only two alternative basic courses of action.

EITHER the authorities must move to control the quantity of money.

OR they must peg the price, that is, the exchange rate of the currency.

Numerous variations on these two alternatives are of course possible, but irrespective of the final course of action chosen, the best solution will be either one or the other, but not a mixture of the two.

The proposals of the Financial Secretary in his Budget speech of February 28 and subsequently gazetted as three bills proposing legislative amendments to the Legislative Council, are preliminary steps in the direction of controlling the quantity of money. For reasons that we spelled out in the previous issue of AMM, these proposals will not be successful in achieving their aim. They are a package of half-measures which address only one of the sources of inflationary money creation in Hong Kong.

The best that can be hoped is that the Government's proposals stimulate debate about the problems and flaws in the Hong Kong banking structure, and thereby lead to further remedial action in the future. Under the present system of Specified Liquid Assets (see box on p.12) the Financial Secretary's proposals will not succeed in controlling the critically important reserve base of the banking system on which Hong Kong's deposit and credit pyramid is erected.

Unless further steps are taken to bring the quantity of money more directly under control, the Budget measures will turn out to have been incomplete. While the government's initial move in the direction of controlling the money supply has been welcomed in many quarters, it is by no means clear that controlling the quantity of money (or money supply) is the best answer for Hong Kong. The question of what is the right solution is the issue we examine here.

The second course of action - pegging the external value of the currency - sounds at first like a return to the pre-November 1974 system when the Hong Kong dollar was pegged to a fixed nominal value of sterling or to a fixed nominal value of the US dollar. However, the drawback of those fixed parity systems was that the value of the foreign currency to which the Hong Kong dollar was pegged proved to be unstable and ultimately resulted in inflation in Hong Kong. The challenge in designing a revised system is to insulate Hong Kong from the consequences

of mistaken monetary policies abroad while preserving all the virtues of Hong Kong's open, adaptable, free market economy.

* * * * *

Before setting out our two alternative schemes for reforming the Hong Kong banking system it is necessary to recognise that the acceptability of any set of proposals will depend largely on the criteria by which those proposals are judged. Without specifying some criteria in advance we run the risk of arousing criticisms which are based not on the explicit mechanisms or instruments we recommend, but on the implicit ends which we seek to achieve. Before embarking on the details of our proposals we therefore enumerate below some of the aims and characteristics which any proposals for reform should have in our opinion.

Premises

1. That the agreed aim of the reformed system should be to stabilise the internal purchasing power of the Hong Kong dollar, i.e. to achieve overall domestic price stability in Hong Kong dollar terms.
2. That the reformed mechanism should take account of Hong Kong's special position in the world economy by interfering as little as possible with free market forces, and should not require or encourage extensive governmental intervention in individual financial markets. This would retain the famed flexibility and adaptability of the Hong Kong economy.
3. That any proposals be compatible as far as possible with the existing institutional framework in Hong Kong, and be impartial as between locally incorporated and foreign incorporated banks.

* * * * *

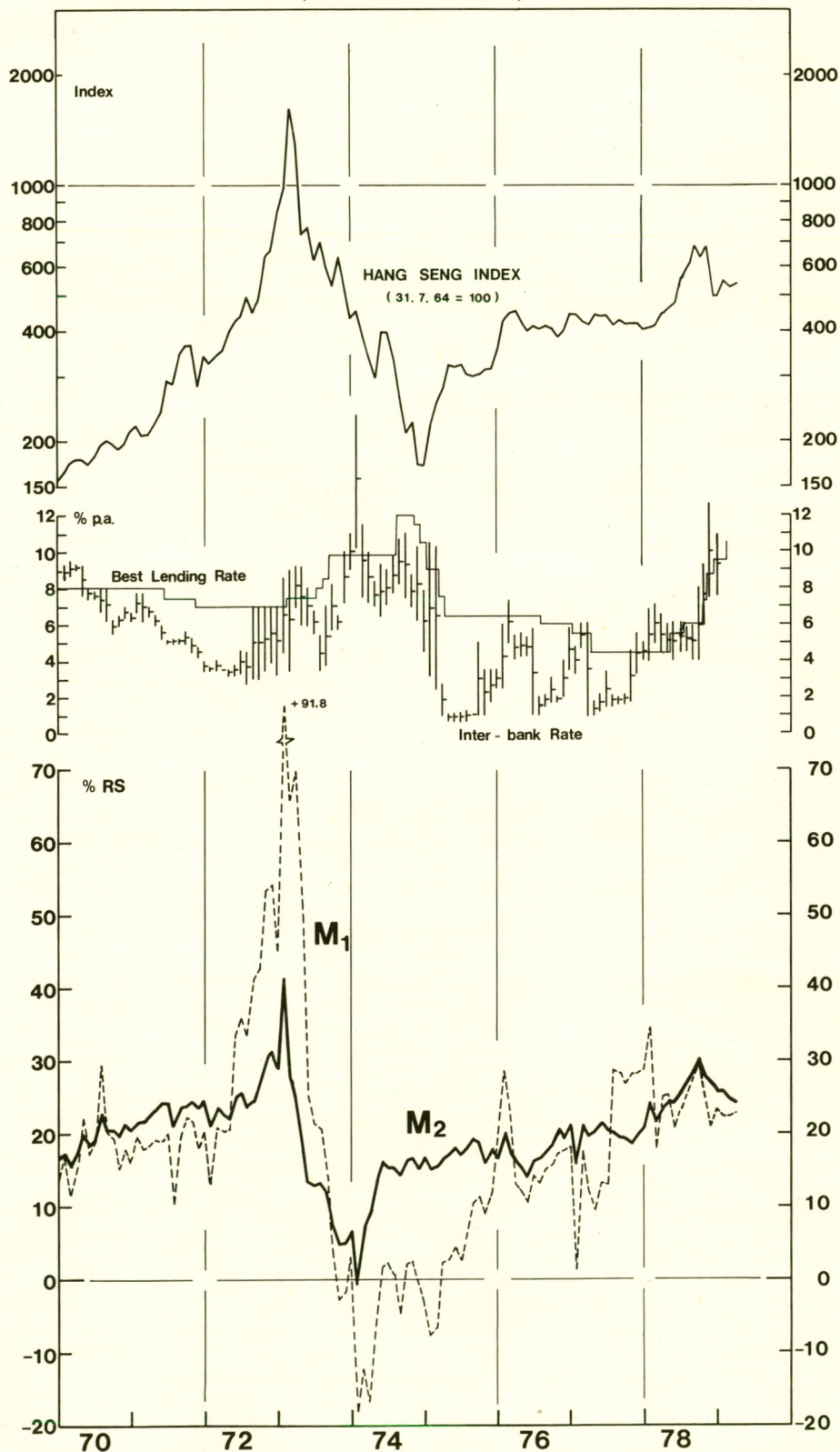
SCHEME 1: CONTROLLING THE QUANTITY OF MONEY

The best way to control the money supply is through regulating the monetary base. Alternative attempts to control the money supply by direct methods such as placing ceilings on bank lending (or "corsets") have been made in several countries but the drawback with these approaches is that they require extensive governmental interference in the process of determining who shall and who shall not be allowed to borrow. Ceilings discriminate amongst the banks to the disadvantage of the borrowers, depositors and shareholders, and they impose an additional reporting burden on private banks, or additional monitoring costs on the government. But more important, loan ceilings are a bad way of controlling the money supply because they only impact a certain part of banks' assets, and they may not affect total bank credit, especially if banks and businesses are adept at devising new credit instruments.

Control of the monetary base - that is, the reserve base

HONG KONG

CHART 2 : MONEY, INTEREST RATES, AND STOCK PRICES



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THE LIQUIDITY RATIO—A MISLEADING INDICATOR

2 DISTINCT MEANINGS OF LIQUIDITY

Much confusion in economic or financial affairs arises from a failure to define one's terms. A good example is the use of the word "liquidity". There are two quite distinct senses in which the word is popularly used, and it is vital to separate them. First there is liquidity as applied to an individual bank or other financial institution. Liquid in this sense means either that the bank or finance company has prudently matched the maturities of its assets and liabilities, or that a significant proportion of its assets are of very short maturity and hence easily realizable (i.e. marketable). Second, liquidity is sometimes used in reference to the financial system as a whole. Typically when interest rates are low people say that the financial system is highly "liquid". Conversely when interest rates are high fears are expressed that the system is "illiquid".

"Liquidity" under the Banking Ordinance

Under Hong Kong's Banking Ordinance (Ch. 155, Section 18) licensed banks are required to observe and maintain certain Specified Liquid Asset Ratios. These requirements were introduced in 1964 following a minor banking crisis, to ensure that individual banks were "liquid" in the first sense by requiring every bank to hold minimum ratios of certain kinds of assets to deposit liabilities. In effect the ratios provided a minimum prudential standard. In addition, Section 23 of the Banking Ordinance restricts loans to any single customer of a bank to 25% of the bank's paid-up capital and reserves, while Section 24 restricts unsecured loans to directors, their relatives or related companies. Finally the Ordinance places restrictions on shareholdings and loans for real estate not used for banking purposes. "Liquidity" in this prudential or balance sheet sense, however, has nothing to do with liquidity in the aggregate or macro-economic sense.

"Liquidity" and Inflation

Liquidity in a broader sense can refer to the quantity of money in relation to the volume of goods and services produced by the economy. In this sense "excess liquidity" occurs when the supply of money persistently grows more rapidly than the demand for it at any given overall price level. In the early stages the greater quantity of money available leads to lower interest rates. At the next stage business activity is stimulated as spending increases. The ultimate result is a general rise in prices (as well as wages, rents, interest rates etc.). If the growth of the money supply now slows down this is typically accompanied by a further rise in interest rates and a "credit crunch" or "liquidity squeeze".

One way to avoid inflation, therefore, is for the monetary authorities to design a system which regulates or controls liquidity in the second sense i.e. the quantity of money relative to the quantity of goods and services produced in the economy. In order to avoid runs on banks, or to ensure prudent banking behaviour, or to protect depositors from loss, or to protect bankers from overextending themselves to individual borrowers it may or may not be regarded as desirable to specify a whole variety of ratios and restrictions along the lines of the Banking Ordinance. But even the most complex and far-reaching controls on liquidity in this balance sheet sense provide absolutely no guarantee that there will not be excess liquidity in an aggregate, macro-economic sense. Hong Kong's Liquidity Ratio is therefore potentially misleading because even if every single bank conforms minutely to the liquidity requirements, the stability of the financial system as a whole may nevertheless be threatened more by the general disturbances that accompany inflation resulting from excess liquidity in the second sense than by any individual instance of illiquidity in the first sense.

of credit expansion - is a better method of controlling the money supply because it leaves market forces intact; the allocation of credit among sectors is not distorted and individual banks are free to compete for whatever share of the market they can obtain. By controlling the quantity of bank reserves, control over the money supply can be quite accurate. It is most accurate when banks' eligible reserve assets are directly controllable, and this is best achieved by defining them narrowly as HK\$ liabilities of the monetary authority. This is because the monetary authority can always control the size of its assets or liabilities. For example, if Government debt or short term loans to certain financial institutions (such as the Discount Houses in the UK) are included in the definition of eligible reserve assets, the banks may be able to sidestep a move by the monetary authority to reduce the monetary base by obtaining other reserve assets in place of those being absorbed by the monetary authority.

A narrow definition of reserve assets would obviate three flaws in the present Hong Kong Banking Ordinance. First, it would prevent the banks from being able to create reserves at will as they are currently able to do by borrowing foreign currency. Second, it would end the anomaly which results from translating foreign reserve assets into Hong Kong dollars at the current exchange rate; at present when the exchange rate depreciates the value of bank reserves expressed in Hong Kong dollars increases. Third, it would eliminate the same anomaly which occurs through including gold as a reserve asset; under the current system whenever the exchange rate falls and the value of gold in HK\$ terms rises, to the extent that banks hold gold their reserve assets increase.

The simplest alternative to the current multiple reserve (or specified liquid asset) structure would be to require all licensed banks to hold deposits at the Exchange Fund equal to a fixed proportion (say 5 pct) of their Hong Kong dollar deposit liabilities. The authorities could then control the available quantity of such reserve assets by open market operations in foreign exchange, in government securities, or in commercial bills issued by the private sector. At present the markets in government securities and commercial paper in Hong Kong are still at an early stage of development, and with the tendency of government to run a fiscal surplus there is little likelihood of much growth in this sector, so operations would be concentrated in the foreign exchange market for the time being. As and when markets in private and government sector paper develop the monetary authority could of course extend its operations to these areas. (See box on p.14.)

The attraction of these proposals is that they require minimum alteration of Hong Kong's current institutional arrangements:

1. Private commercial banks could continue to issue bank notes as in the present system. Certificates of Indebtedness (CI's) would continue to be issued in exchange for domestic deposits or foreign assets placed with the monetary authority,

A MONETARY AUTHORITY WITH NO GOVERNMENT DEBT

It is sometimes stated by private bankers and by public officials that the lack of any government debt in Hong Kong hinders the establishment of a Monetary Authority. This argument is mistaken. There is no reason why a Monetary Authority or Central Bank needs to conduct its operations in Government debt, nor any reason why the Monetary Authority should hold any government debt as a part of its assets.

Consider the situation in Japan from 1949 to 1973. Throughout most of that period the Japanese government maintained a budget surplus, and yet the Bank of Japan supplied reserves to the banks either by purchasing foreign exchange and selling yen to the City Banks, or by discounting private sector export bills or by making direct loans to the banks. The Bank of Japan held almost no government debt. Yet despite the budget surplus the money supply grew rapidly, and Japan experienced periodic bouts of inflation.

Consider the situation in Singapore today. The Government of Singapore issues substantial quantities of debt, but almost all of it is purchased by the Post Office Savings Bank and the Central Provident Fund; almost none is purchased by the Monetary Authority of Singapore (MAS). The assets of the MAS consist mainly of foreign exchange (92% as at the end of March 1978) and the MAS conducts its operations almost entirely in the foreign exchange market. Government debt exists, but, except for small-scale operations in Treasury Bills, it is virtually ignored for the purposes of conducting monetary policy.

It is true that Central Banks such as the U.S. Federal Reserve System or the Bank of England conduct their open market operations largely in government debt, but there is absolutely no reason why this should necessarily be so. The U.S. Federal Reserve could just as well purchase Commercial Paper or Bankers Acceptances instead of Treasury Bills and Government Securities. Indeed, in a classic nineteenth century text, Walter Bagehot wrote that there was no reason why the central bank shouldn't discount even furniture to supply the need for credit if no other instruments were available.

In short, the proposition that Hong Kong's lack of government debt makes it difficult to establish a Monetary Authority is a red herring. The only logical consequence is that the assets of the monetary authority would have to be comprised of instruments other than government debt, i.e. foreign exchange or private sector debt instruments such as export bills, or certificates of deposit.

and the three note-issuing commercial banks would continue to issue bank notes against CI's.

2. The government could retain its accounts with the commercial banks as at present. In monetary systems where the government's deposits are maintained at the central monetary authority and not at the commercial banks the irregular pattern of tax collection and expenditure causes fluctuations in the volume of credit creation by the commercial banks unless deliberate offsetting action is taken. The advantage of the government keeping its accounts with the commercial banks as at present is that these disturbances would be avoided.

3. Supposing there was a change in policy resulting in the Hong Kong Government shifting to a persistent budget deficit, it would be highly desirable if the automatic monetisation of this debt could be prevented, thus avoiding the inflationary effects of such a policy. Provided the government maintains its fiscal accounts at the commercial banks it is in an analogous position to ordinary corporate entities: if it experienced a cash deficit it would have to borrow temporarily from the banks, or the public. In neither case is new money created. But if the government maintained its accounts only with a monetary authority the temptation to finance the deficit by creating the necessary new funds whenever the need arose would be substantially greater. In other words the privileged position of the government would make it more difficult for the monetary authority to resist financing short term government requirements by simply printing the money. Our proposals do not place the government in any such privileged position.

The main disadvantage of these proposals is that although the structure of the revised banking system and the Exchange Fund (see also box on pp.16-17) is easy enough to set out, the operating procedures for the monetary authorities are much more difficult to define and much more difficult to reconcile with our criteria of non-intervention and impartiality. In the first place it has to be decided at what rate the reserve base of the system should be allowed to grow, and it is by no means easy to select the rate which would be right for Hong Kong's changing circumstances.* Meanwhile there would be the clear danger of overshooting or undershooting the appropriate rate with accompanying disruptions to the domestic economy. Second, once it was clear that the authorities had discretion to influence interest rates and exchange rates in the short run, no doubt political pressures would build up in favour of offsetting each disturbance that happened to occur, and before long the officials operating the monetary authority would face substantial temptations to interfere. Even if they acted with the best of motives, their powers to interfere would be enormous, and it is doubtful if they would long be able to resist the political pressure to "do something" for various pressure groups (e.g. exporters, home-buyers, or farmers).

* Technically the right rate requires calculating the demand for money function etc.

LEGISLATIVE CHANGES REQUIRED TO CONTROL THE MONEY SUPPLY

Effectively to control Hong Kong's money supply, two sets of actions need to be taken:

(A) Redefine the reserve base and its relation to deposits.

(B) Provide for effective control of the reserve base.

The first step requires amendments to the Banking Ordinance, while the second requires alteration of the Exchange Fund Ordinance.

A. Redefining the Reserve Base

A serious flaw in the present Banking Ordinance is that licensed banks can create liquid assets at their own discretion simply by borrowing foreign funds from overseas correspondent or associated banks.

If it is decided to control the quantity of Hong Kong dollar money supply, then the reserve base must be defined in such a way as to make this feasible. The simplest way to do this is to require all banks to hold a fixed percentage of their Hong Kong dollar deposit liabilities in the form of currency and deposits at the Exchange Fund (see below). Because the Exchange Fund would have the ability to alter the size of its balance sheet at will, the authorities would thus acquire direct control over the reserve base and hence over the money supply. It is important that the revised definition of reserves does not include any assets which are not liabilities of the Exchange Fund because this will impair the ability of the authorities to control the growth of the reserve base.

B. Controlling the Reserve Base of the Banking System

To provide effective control of the reserve base of the banking system while preserving the system of private note issue the following modifications could be introduced:

Assets of the Exchange Fund

- (1) Prohibit the Exchange Fund from holding HK\$ deposits with commercial banks in Hong Kong, but require all licensed banks to hold accounts with the Exchange Fund. (See (4) below.) N.B. The Exchange Fund could still hold foreign currency deposits.
- (2) The Exchange Fund could hold (a) foreign assets of any kind (these would mainly be foreign government securities) or (b) Hong Kong \$ denominated private

sector instruments or (c) Hong Kong Government or government-guaranteed debt instruments.

Liabilities of the Exchange Fund

- (3) The Exchange Fund would continue to issue CIs to the commercial banks, and the banks would pay for them either with foreign assets or by debiting their reserve accounts with the Exchange Fund (see (4) below).
- (4) Require all licensed banks to hold reserve deposits with the Exchange Fund. The Exchange Fund could vary the quantity of total bank reserves by buying or selling any of the assets in (2) above, and its objective would be to make this total grow at a specified rate which might be varied annually or semi-annually. The interest rate used for 2(b) or 2(c) could be set by reference to the interbank rate, but it would be important to ensure that this rate never became an objective of policy. Settlement of any HK\$ cheques drawn on or payable to the Exchange Fund would be settled through crediting or debiting the accounts of commercial banks at the Exchange Fund. Such transactions would directly affect the reserve base and banks would have to adjust their lending to keep their reserve/deposit ratios on target.
- (5) Capital Accounts and retained earnings of the Exchange Fund. Since the Exchange Fund will be holding substantial earning assets against almost costless liabilities, it will make sizable profits. As with central banks elsewhere in the world, the seignorage or earnings above a fixed limit could be transferred to the government's fiscal accounts on a specified annual, semi-annual, or quarterly basis. This would be consistent with the objectives of the Exchange Fund as set out in the Exchange Fund Ordinance (Cap. 66 Section 3) that the Exchange Fund "shall be used for the purpose of regulating the exchange value of the currency of Hong Kong". To put it another way, the objective of the Exchange Fund would not be (nor ever should have been) to conduct its operations so as to maximise profits. (It could of course very easily do so by expanding its balance sheet, thus expanding Hong Kong's reserve base and hence the money supply, but clearly this would be detrimental to our objective of stabilising the internal purchasing power of the Hong Kong currency.)

Other Accounts of the Exchange Fund

The Exchange Fund would no longer hold HK\$ deposits with the commercial banks in Hong Kong. Outside Hong Kong it would of course be permitted to maintain foreign currency and custodian accounts with banks or any appointed agents.

SCHEME 2: CONTROLLING THE EXCHANGE RATE

The major disadvantage of Scheme 1 is that the guidelines for monetary policy are uncertain and left to the discretion of the administrators. There are few checks to ensure that the monetary policy is compatible with long-run price stability. Through error or design the rate of growth of the money supply may deviate from the rate required for long-run price stability - but the consequences of such deviations will not become apparent in the economy until several months or even years later. In other words the feed-back to the monetary authorities of the consequences of their policies is delayed.

This is of course a problem faced by all countries whose monetary authorities aim to control the quantity of money. Like the pilot of an oil tanker, the authorities may not realise the ship is running onto the rocks until it is too late to change course. There is a danger that monetary policy will oscillate between over-expansion and over-correction with the consequent familiar stop-go effects on economic activity.

If instead of using economic indicators within the Hong Kong economy as guidelines for monetary policy an 'external' rule could be devised to regulate monetary expansion then the tendency for monetary policy to waver in response to the consequences of earlier mistakes would be avoided. To extend the analogy, if the only guide for steering the oil tanker is a light on the bow, then the man at the helm will be aiming at a target which moves in response to his own actions and the ship will wander erratically on the ocean. If instead the helmsman could aim for a lighthouse on the horizon, then his course would be steady, and his target would be independent of the movements of the ship.

In the 1960's the lighthouse was a fixed rate of the Hong Kong dollar against Sterling. The Exchange Fund bought and sold foreign exchange in whatever amounts were necessary to keep the exchange rate fixed. The money supply adjusted, and the price level in Hong Kong also varied, but the automatic consequence of the pegged exchange rate was that the price level in Hong Kong in the long-run followed the price level in the UK.

The target of the Exchange Fund was neither the domestic price level, nor the money supply nor interest rates (which were all like lights on the bows of the ship), and these variables were all left to market forces, but nevertheless the long-run trend in the price level was effectively linked to the trend in prices in the UK.

The problem with the pegged exchange rate was that the currency to which the HK dollar was pegged was not inflation-proof: as first the pound sterling, then the dollar succumbed to inflation the HK dollar was dragged into the same mire. If the HK dollar could be pegged to a currency which was guaranteed inflation-proof then HK would also be free from inflation. Although from time to time a few countries achieve virtual

price stability for short periods there can be no assurance that they will continue to follow non-inflationary policies in the future, so an alternative might be to adjust the peg for inflation in the other currency.

As an example, and only as an example, suppose the Exchange Fund were to follow a rule that it must aim to keep the purchasing power of the Hong Kong dollar constant in terms of the commodities comprising the wholesale price index in the USA. Then the Fund would buy and sell US dollars at an exchange rate which moved at the rate of increase of wholesale prices in the USA. Suppose at the beginning of the year the exchange rate of the HK\$ was HK\$5.00 = US\$1.00 and the rate of inflation in wholesale prices in the USA is estimated at 10% per annum, then the Exchange Fund should guide the Exchange Rate to HK\$5.00 = US\$1.10 by the end of the year or HK\$4.55 = US\$1.00. If this guideline is followed then in the long run prices in Hong Kong, adjusted for exchange rate changes, cannot move far out of line with prices in the USA. Since the exchange rate of the Hong Kong dollar rises at the same rate as US prices this ensures that long-run price stability is maintained regardless of the inflation rate in the USA.

There are a number of problems associated with this policy:

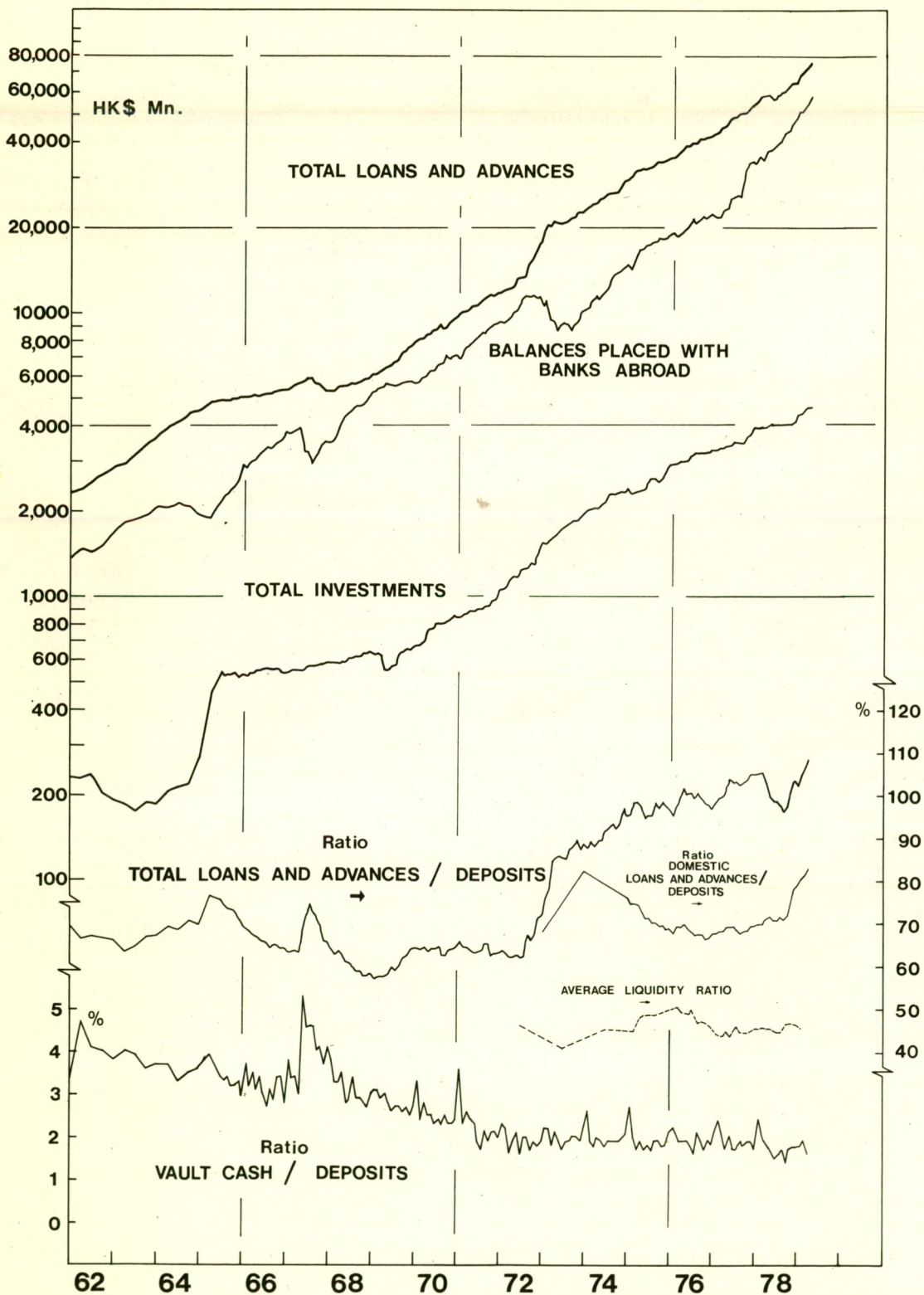
Firstly, wage/price controls, exchange rate manipulations, political instability and many other factors can distort the US wholesale price index and/or the exchange rate of the currency with third countries against which the Hong Kong dollar is to be compared. To minimize these dangers, the single currency could be replaced by a basket of currencies each appropriately adjusted for inflation, so abnormalities associated with any one currency would have less effect.

Secondly, the appropriate measure of inflation in each currency is open to debate: should it be a wholesale price index, consumer price index, export price index or GNP deflator or some combination of these? This is really not a serious problem. The world is not perfect and inflation is an imprecise concept; as long as some index is agreed upon and the guideline followed, inflation in Hong Kong will be negligible.

Thirdly, a more sophisticated approach would be to use 'expected inflation rates'. Since inflation responds only with a lag to excessive monetary expansion, adjusting merely for present inflation rates would not prevent excessive monetary growth overseas generating a monetary explosion in Hong Kong and a subsequent inflation. Though the price rises would be eliminated eventually by the exchange rate policy the inflation and subsequent deflation would cause unnecessary instability. By adjusting the exchange rate relative to expected inflation rates i.e. with regard to monetary policy in other countries and not merely their current inflation rates such disturbances could be reduced. The estimation of expected inflation rates would however involve personal judgments and subjectivity which would reduce the 'automatic' nature of the system. This

HONG KONG

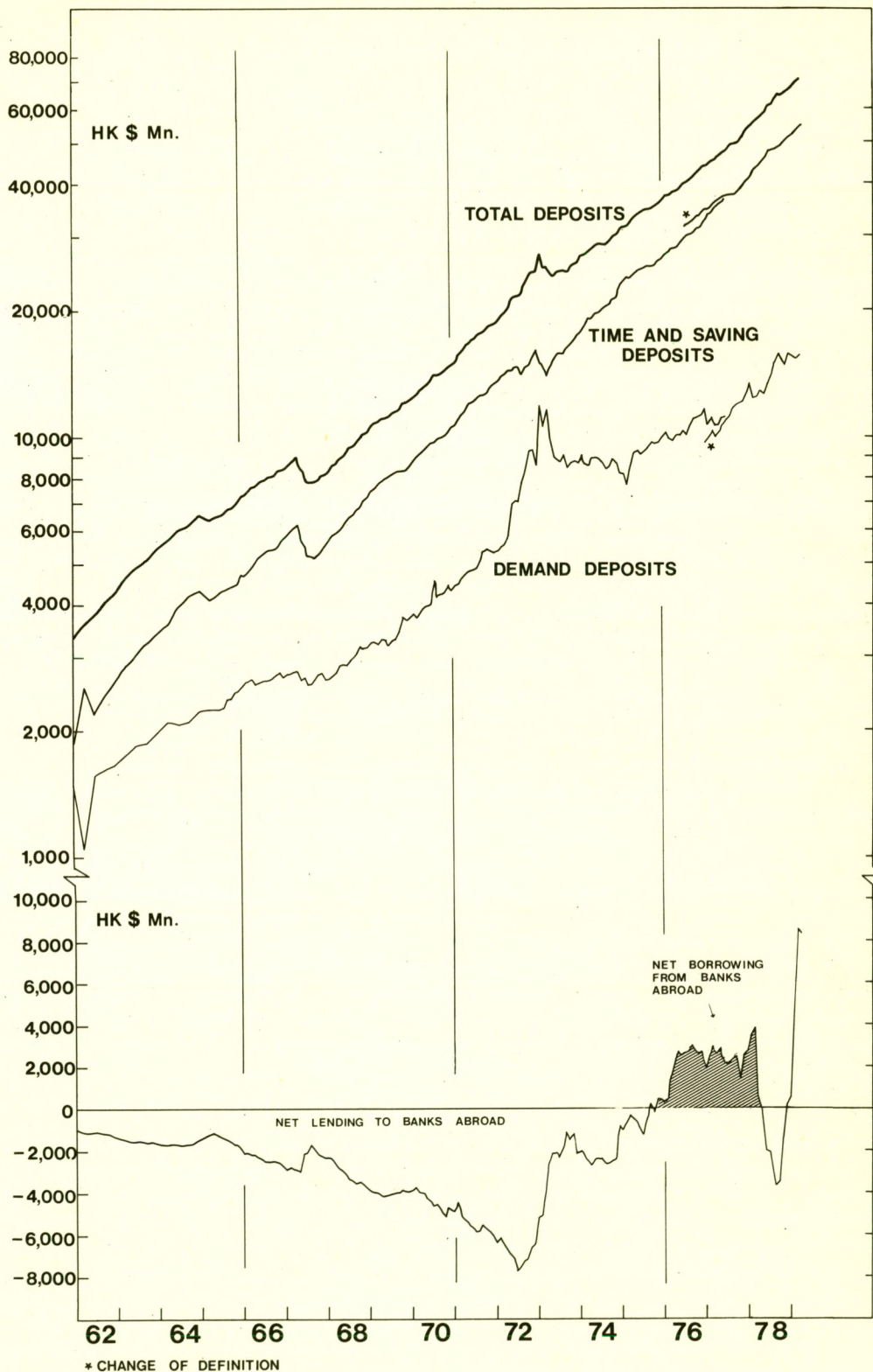
CHART 3 : BANK ASSETS



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HONG KONG

CHART 4 : BANK LIABILITIES



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problem would also be reduced by including a large number of currencies in the basket, so the leads and lags of monetary policy and inflation in any one country would have less effect on the Hong Kong economy.

Fourth, the appropriate disclosure policy must be carefully considered. Would announcement of the exchange rate policy rule lead to speculation and exchange market instability as operators try to out-guess the authorities? Most countries which 'peg' their currencies to a basket do not disclose the weighting of the currencies in the basket or their precise policy of intervention on the foreign exchanges. There is considerable and mounting evidence that both Singapore and Switzerland have adopted policies similar to the proposals outlined here and they have also maintained a deliberate policy of vagueness and secrecy with regard to their exchange rate intervention.

It is not intended to give a detailed description of the 'real exchange rate' proposal here, but merely to discuss the issues involved. As far as we can judge it requires very few changes to the existing monetary system.

1. The Exchange Fund must revert to the situation of the 1960s when only foreign currency assets could be held by the fund. In order to issue new banknotes the commercial banks would have to submit foreign currency at the exchange rate announced by the Exchange Fund, in return for Certificates of Indebtedness. The commercial banks would no longer be able to submit Hong Kong dollar deposits.
2. The 'real exchange rate' system requires no change to the existing specified liquid assets system described in the Banking Ordinance. Though far from ideal the existing arrangements are irrelevant to the operation of the 'real exchange rate' system.
3. There would be no need to set up a new monetary authority or increase the powers of the Exchange Fund; there would be no need for controls on interest rates or credit expansion since these would be regulated by the balance of payments. In effect Hong Kong would return to the automatic adjustment mechanism which operated until 1974, only this time the Hong Kong dollar would be pegged to an artificial inflation-free currency.

SUMMARY AND CONCLUSION

In order to stabilise the domestic purchasing power of the Hong Kong currency and stop inflation, while at the same time preserving the free market strength and adaptability of Hong Kong's economy and maintaining the present institutional structure, the monetary authorities can either control the money supply or peg the currency.

If they choose the former, this brings with it the danger of more extensive government intervention, and it will certainly

require some institutional changes if it is to work successfully. If they choose the latter - pegging the exchange rate - it will be important to peg to an artificial unit of stable value rather than to a nominal foreign currency of unreliable value. At the same time it will be essential for the authorities to abandon any attempt at controlling the money supply because of the logical impossibility of both pegging the currency and controlling the money supply.

At present, however, the authorities are neither effectively controlling the money supply nor pegging the currency to a stable unit of value. Unless further action is taken, present policy could well prove to be a recipe for further depreciation. The only consideration which would modify this conclusion is the short-term behaviour and structure of interest rates, and their relationship to monetary growth - a topic we shall consider in a future issue of AMM.

SINGAPORE

A CASE OF MONETARY RESTRAINT

Compared with most other countries of the Far East monetary growth in Singapore has been notably restrained over the past few years. Apart from a brief upturn in M_2 in 1975, the growth of this monetary aggregate has remained in the 8-12% range, decelerating in the second half of 1977 and accelerating again in the first half of 1978. Between 1974 and 1976 M_1 oscillated around M_2 , but since 1977 it has followed a path much closer to M_2 .² What is the explanation for this relative stability in contrast with the instability and wide fluctuations in monetary growth of countries like Taiwan, Korea, Hong Kong, or the Philippines?

One view which is widely held and commands attention is that deposits at the Post Office Savings Bank (POSB) and the Central Provident Fund (CPF) have been growing very rapidly at the expense of the traditional commercial banking sector, eroding the banks' market share. If POSB and CPF deposits were to be consolidated with commercial bank statistics, monetary growth would be much higher.

Another more fundamental view is that the monetary policy of the authorities, though not overtly aiming at slow monetary growth, necessarily produces slower monetary growth as a direct consequence of their exchange rate policy. This argument holds that given the exchange rate policy pursued by the Monetary Authority of Singapore (MAS), the resulting balance of payments has simply not permitted a rapid growth of the money supply.

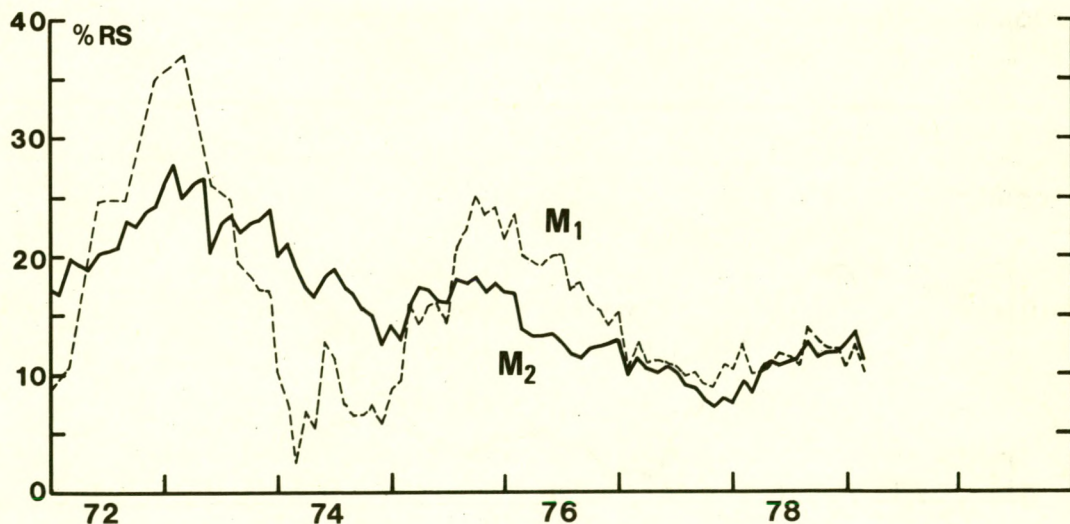
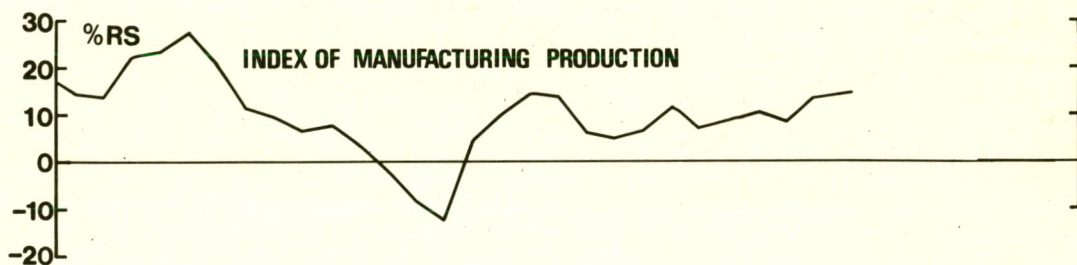
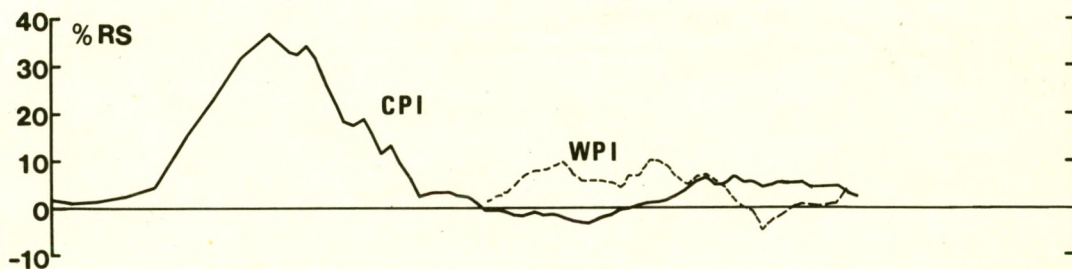
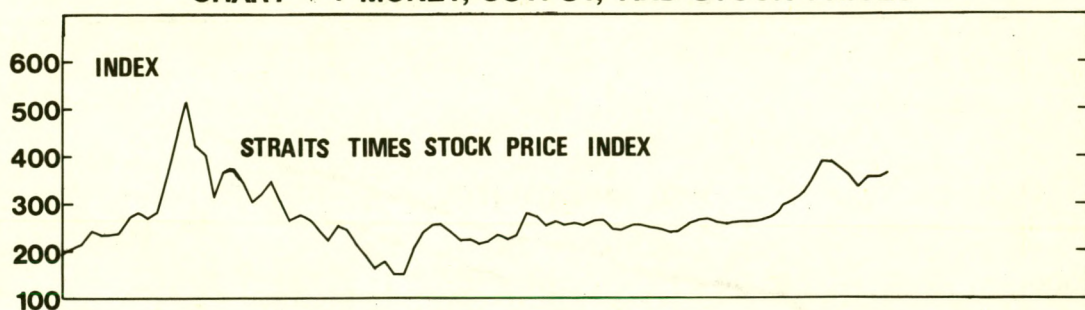
1. The Growth of Other Financial Intermediaries

Although the Post Office Savings Bank is one of the oldest financial institutions in Singapore, it is only in recent years that it has come to play a prominent role in the monetary system. In the decade prior to 1968 the POSB experienced net withdrawals every year, but in that year a savings bank committee was formed and changes were recommended to revitalise the POSB. Gradually the level of deposits stabilised, and, based on new legislation in October 1971, important structural and managerial reforms were made. Management of the banking side was separated from that of the postal services, and the financial management was vested in a Board of Directors appointed by the Minister for Finance. These changes took effect from January 1972 and it is from that time that the POSB really began to compete with the ordinary commercial banks.

In recent years the extension of the POSB's branch network and an ambitious programme of computerisation has placed the POSB in a very strong competitive position. In addition, the payment of salaries through the POSB to those males doing compulsory military service together with the provision of a wide variety of GIRO payment schemes

SINGAPORE

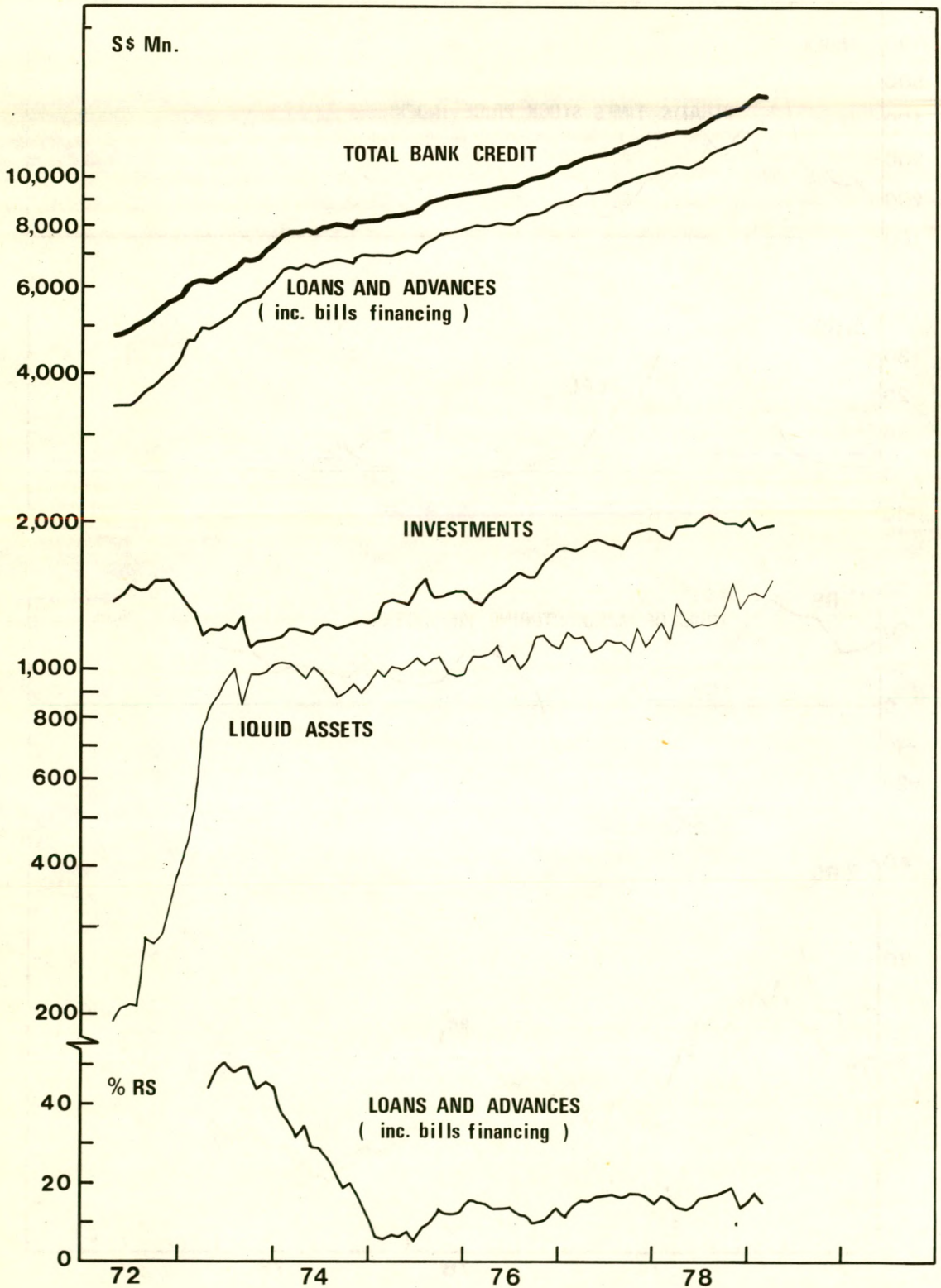
CHART 1 : MONEY, OUTPUT, AND STOCK PRICES



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SINGAPORE

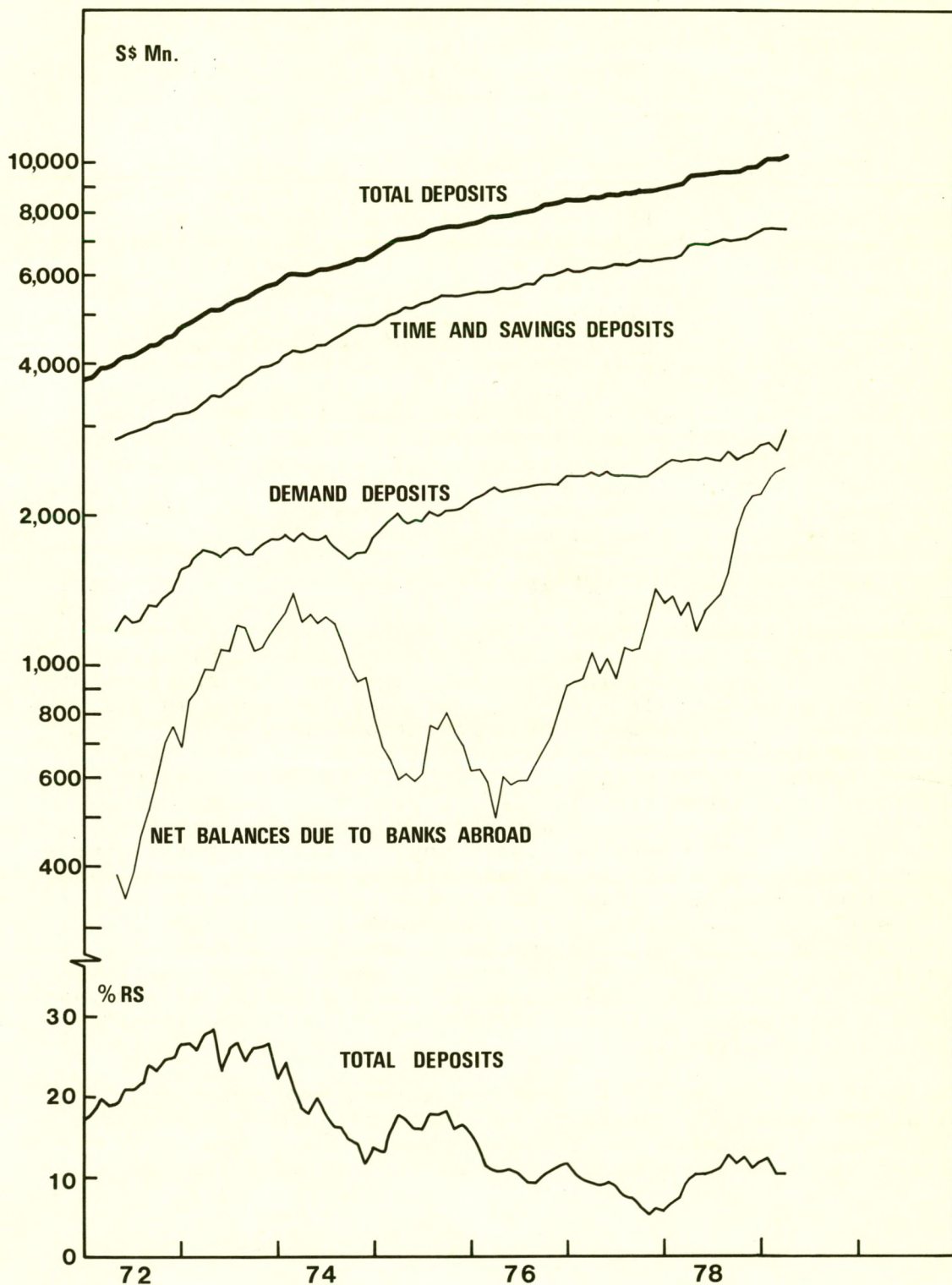
CHART 2 : BANK ASSETS



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CHART 3 : BANK LIABILITIES



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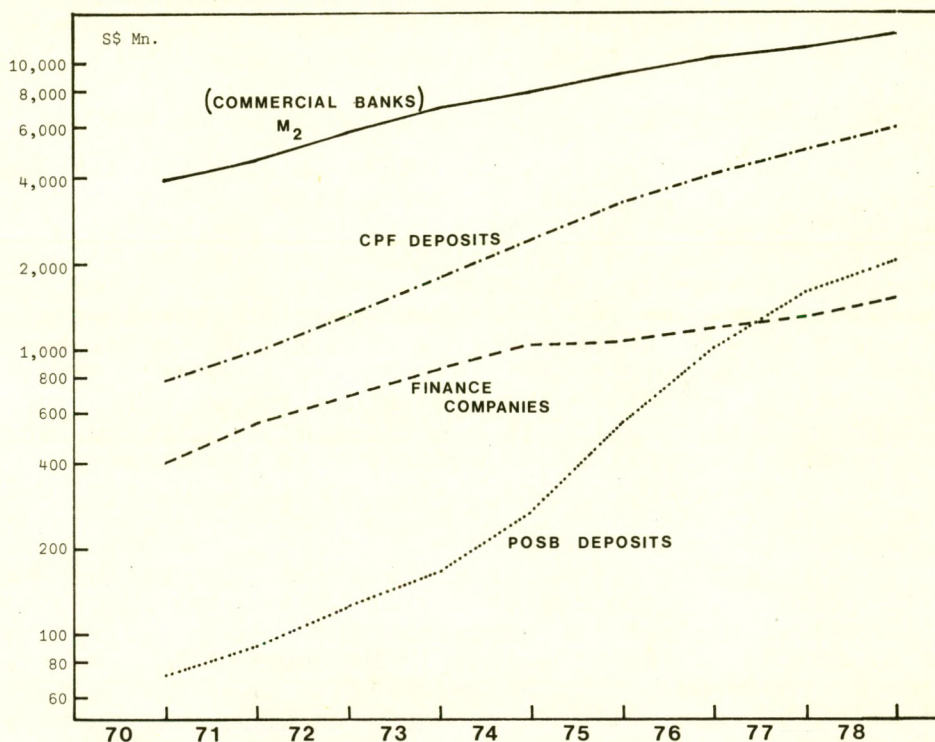
(automatic transfers to pay utility and other bills) have increased both the number of account holders and the number of transactions per account. The POSB is also moving "downstream" to the supermarkets where point-of-sale terminals will enable depositors to check their current balance, transfer savings to current account, deposit money and pay bills. Judging by these characteristics it would seem appropriate to include POSB deposits in the definition of money in Singapore.

If deposits at the Post Office Savings Bank are considered as money, it is proper to add them to the M_2 definition of money supply. The official definition of M_3 (see Chart 7) also adds in net deposits of Finance Companies. However, the test of the validity of M_3 is not so much in its definition, as in its power to explain better the behaviour of nominal income (or GNP). At the end of 1978 gross deposits at the POSB were equal to 20% of the deposits at commercial banks (included in M_2), which explains the relatively small deviation between the M_2 and M_3 growth rates. (M_3 grew by 15% in the year to December 1978 compared to 12.6% over the same period for M_2 .) Thus despite their astonishing growth rate of 51.6% p.a. over the period 1970-78, POSB deposits have not seriously undermined monetary policy. Of course they have drawn business away from the commercial banks, but their growth has not greatly altered the thrust or direction of monetary growth.

Funds held by the CPF are rather a different matter as it would be wrong to consider them as money. Whereas funds held at the POSB can be withdrawn immediately and used to effect payments, funds held at the CPF represent the compulsorily accumulated savings of individuals. However, savings are not the same as money. In any case, for most instances in the private sector individuals or corporations must write cheques drawn on their accounts at commercial banks in order to finance the transfer of funds into the CPF. Therefore unless the MAS conducts operations with the CPF, providing it with funds which it can then lend out and which may be redeposited with itself or with the banking system thus creating a fresh source of deposits, its liabilities cannot be regarded as money, and it would not be appropriate to add the liabilities of the CPF - despite their imposing size and growth rate - to the deposit liabilities of the banking system to arrive at a broader definition of money. (For reference, Chart 5 shows the rate of change of various definitions of money starting with M_2 and gradually broadening to include CPF deposits in the final, broadest definition.)

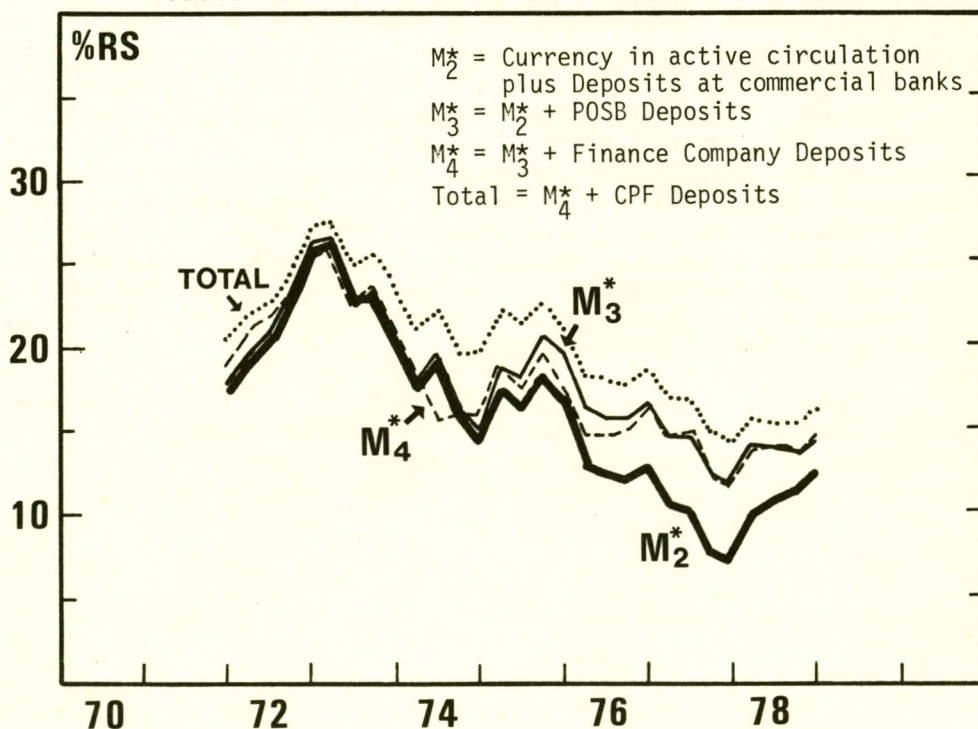
As an interim conclusion it can therefore be stated that the POSB does appear to have been a source of monetary expansion. Although the CPF has grown rapidly, its liabilities cannot properly be construed as affecting monetary

SINGAPORE
CHART 4: GROWTH OF DEPOSITS AT DIFFERENT FINANCIAL INSTITUTIONS



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CHART 5
SINGAPORE: GROWTH OF DIFFERENT MONETARY AGGREGATES



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growth.* However, since even the growth of M_3 has been restrained by comparison with the growth of the money supply in other East Asian economies, another deeper explanation for Singapore's experience must be sought.

2. Exchange Rate Policy

An alternative explanation might be that the MAS has simply pursued a low monetary growth target. But we know that there is no explicit monetary growth target; also the Annual Reports and official statements of the MAS make no mention of seeking to achieve specific M_1 or M_2 or even M_3 growth rates. On the other hand we also know that the MAS does have a deliberate policy of managing the exchange rate of the Singapore dollar in relation to other currencies. As its guiding principle the MAS calculates an effective exchange rate index which is comprised of foreign currency units weighted approximately according to the bilateral trade structure of Singapore. What does this policy imply for monetary growth?

In contrast to South Korea where the currency has been kept rigidly pegged to the US dollar, Singapore's currency has inched up against the American unit. Compared with a rate of S\$2.45 to the US dollar in December 1976, the rate had moved up to S\$2.16 in December 1978, an upward revaluation of nearly 7%. But while Korea experienced a huge balance of payments surplus as the US economy was expanding and the US currency was depreciating on world currency markets, Singapore's experience was much more muted.

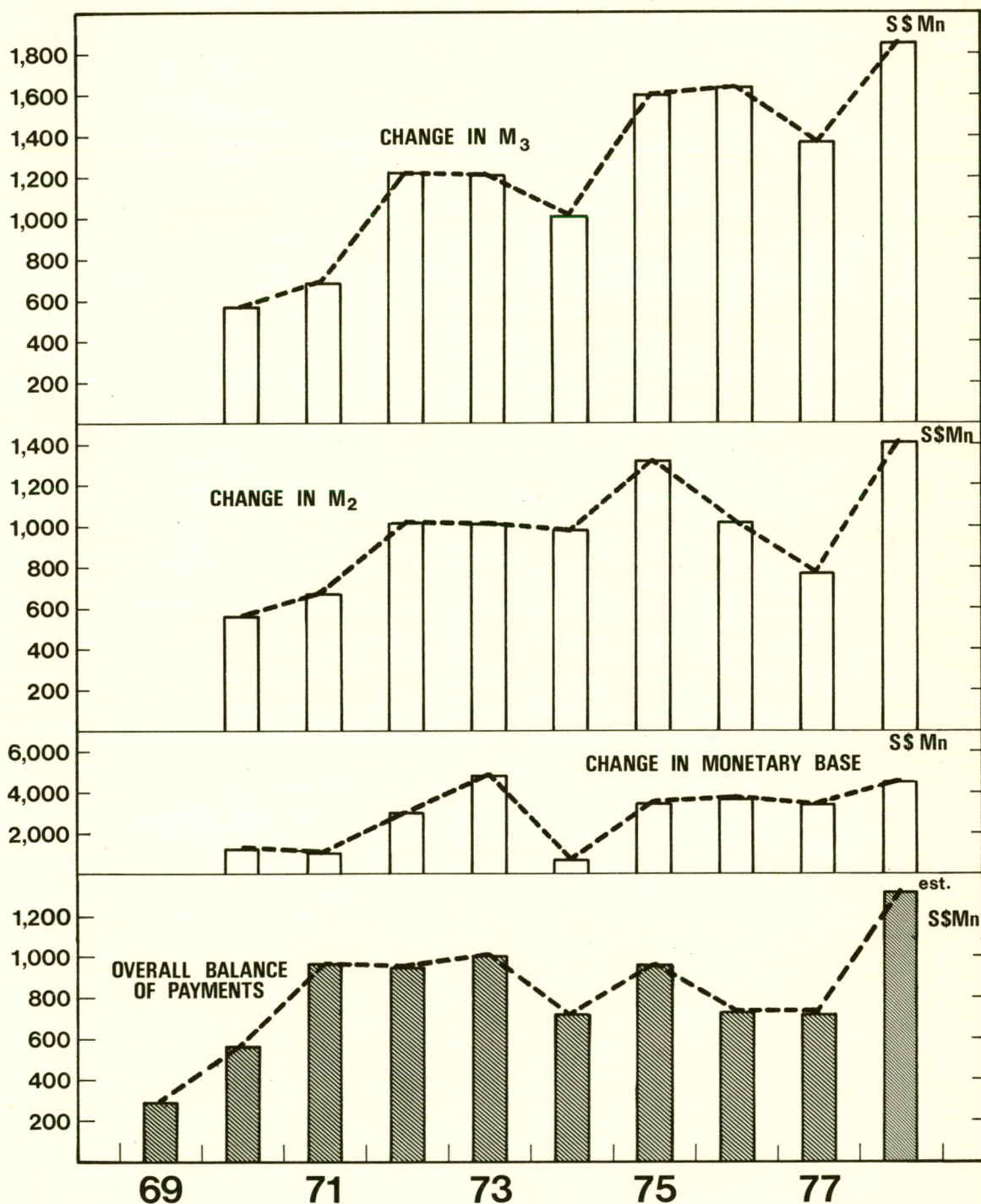
By steering the currency upwards the MAS avoided the accumulation of excessive balance of payments surpluses and prevented the reserves of the banking system growing too rapidly. In so doing they escaped, at least to some extent, the full impact of a large balance of payments surplus being reflected in a surging Singaporean money supply. Chart 6 illustrates the impact of the balance of payments on bank reserves, and the impact of bank reserves on the money supply. Although the relationships are not perfect - due in part to changes in reserve requirements - the chart makes the key point: since the early 1970s changes in the money supply are largely explained by changes in bank reserves, which are in turn associated with changes in the international balance of payments.

By floating the currency entirely free the authorities would have been able to insulate themselves altogether, but this would have required a deliberate policy to control the money supply, something the authorities have been

* As a matter of record, there can be no question that assets at the CPF have grown very rapidly, and therefore the CPF now accounts for a larger proportion of total assets in Singapore than in the past. In effect a greater share of assets is now held by a public sector body (as an intermediary), but this transfer of assets from private to public hands is quite separate from the issue of whether or not the quantity of money has grown more or less rapidly. The same transfer could have occurred with double the rate of monetary growth or indeed half the rate of growth.

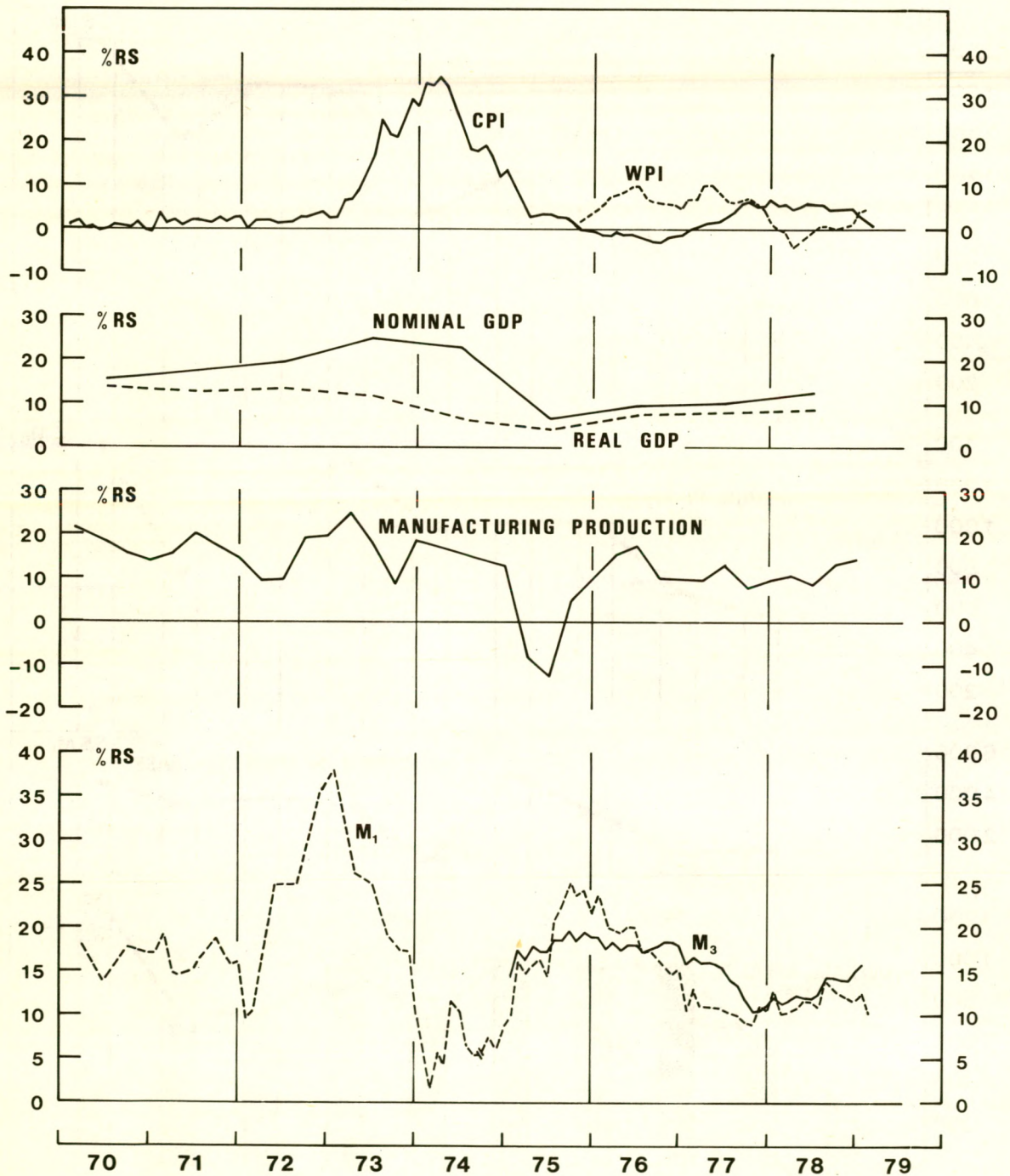
SINGAPORE : CHART 6

IMPACT OF THE BALANCE OF PAYMENTS ON MONETARY AGGREGATES



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CHART 7 SINGAPORE MONEY, OUTPUT AND PRICES



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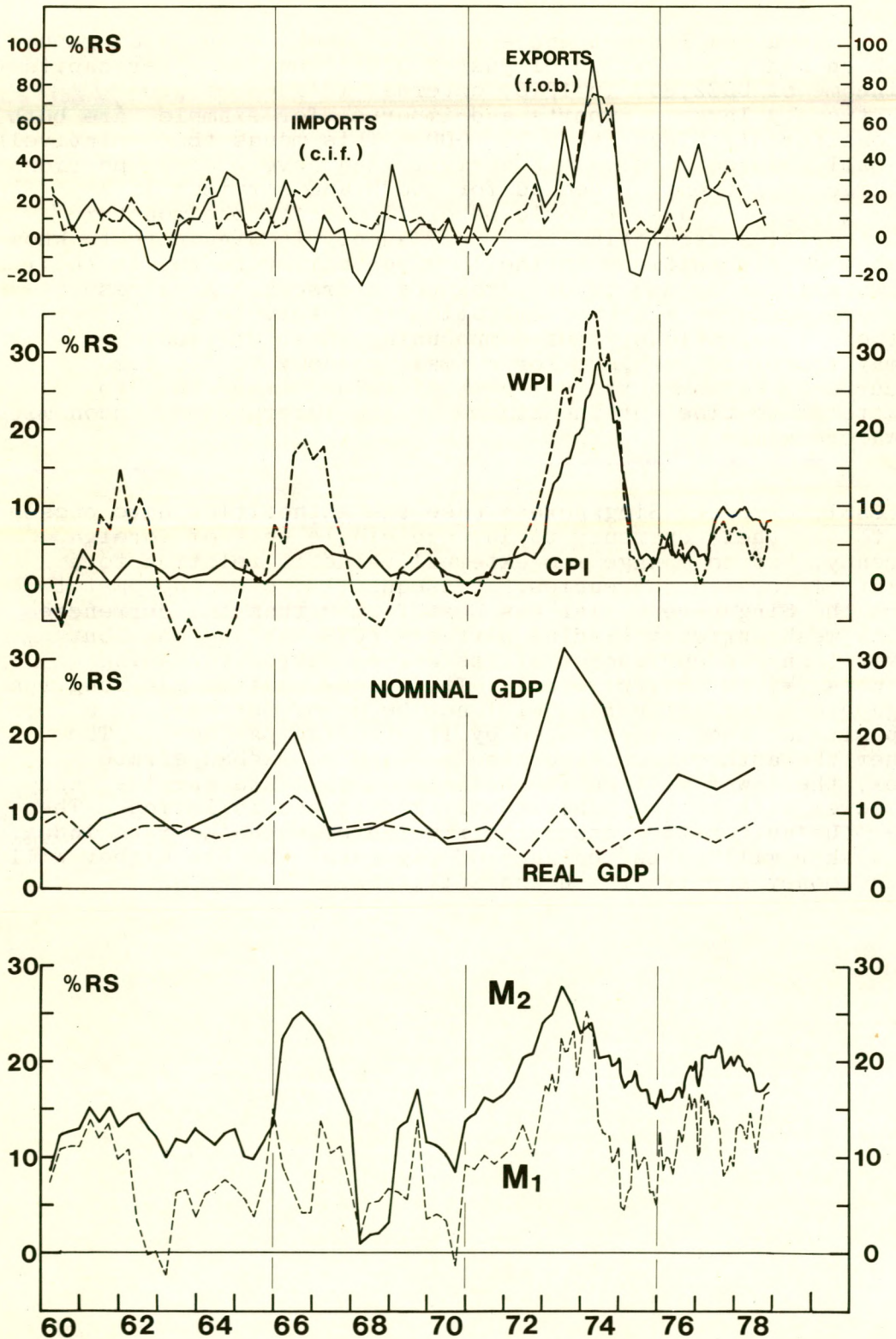
reluctant to embark upon. Would it be wise for the authorities to control the money supply rather than the exchange rate?

In a small urban and entrepot economy such as Singapore, which had a population of just 2.3 million and a per capita income of US\$2,800 in 1978, external influences are extremely large. Exports and imports, for example, are both considerably bigger than the GDP. This means that relatively small changes in economic activity can have a disproportionately large impact on the demand for goods and services in Singapore. Hence it would be difficult for the monetary authorities regulating the money supply in Singapore to know whether fluctuations in the local economy were due to their own actions or due to disturbances overseas. As a result there would be a great temptation to intervene and offset these fluctuations, thus compounding their difficulties. It may therefore be wiser for a small economy to tie its currency to some external unit of value rather than to attempt to ride out the storms on the international economic waters alone.

FORECAST: In the Singaporean case the authorities have chosen not to peg their currency to any one single unit of foreign currency, but to manage its external value in relation to a basket of foreign currencies. Consequently, over the past two years the Singapore dollar has been firmer than the currencies of its weak currency trading partners (US\$, A\$ and C\$), but weaker than the currencies of its strong currency trading partners (¥, DM, Sw.Fr. etc.). It follows that in the long run Singapore's inflation rate will not be zero, but will be a composite of that experienced by its trading partners. The higher the authorities steer their weighted exchange rate index, the lower will be the balance of payments surplus, and the lower will be the money supply growth and inflation. The lower the authorities steer their weighted exchange rate index, the weaker will be the balance of payments, and the higher will be the money supply growth and inflation.

THAILAND

CHART 1 : MONEY, OUTPUT, PRICES, AND TRADE



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THAILAND

DELIBERATELY TIGHTENING UP

Domestically generated inflation in a closed economy is not very helpful; it is particularly useless in an open economy. This is a lesson Thailand has been learning in recent years.

Since Dr. Puey's reign over the Thai central bank in the sixties, economic policy has become gradually more 'progressive' and the traditional Siamese image of financial rectitude has given way to a more accomodating approach. The results: accelerating inflation, a weakening balance of payments and a depletion of foreign reserves are now causing considerable problems for the authorities.

As explained in an earlier issue of AMM (Vol. 2 No. 3) the deterioration became apparent in the late sixties when growing budget deficits became harder to finance in non-inflationary ways and over the past ten years the balance of payments has shown an underlying trend of weakness. In 1970 and 1971 when world commodity demand slowed down, Thailand's balance of payments worsened reflecting the deterioration in export prices, but the shortfall was made up in the following three years of surpluses and the foreign reserves doubled between 1971 and 1974 to reach US\$1,564 million. However the underlying monetary policy was deteriorating and in the following years domestic credit expansion continued to grow rapidly even though the foreign reserves declined.

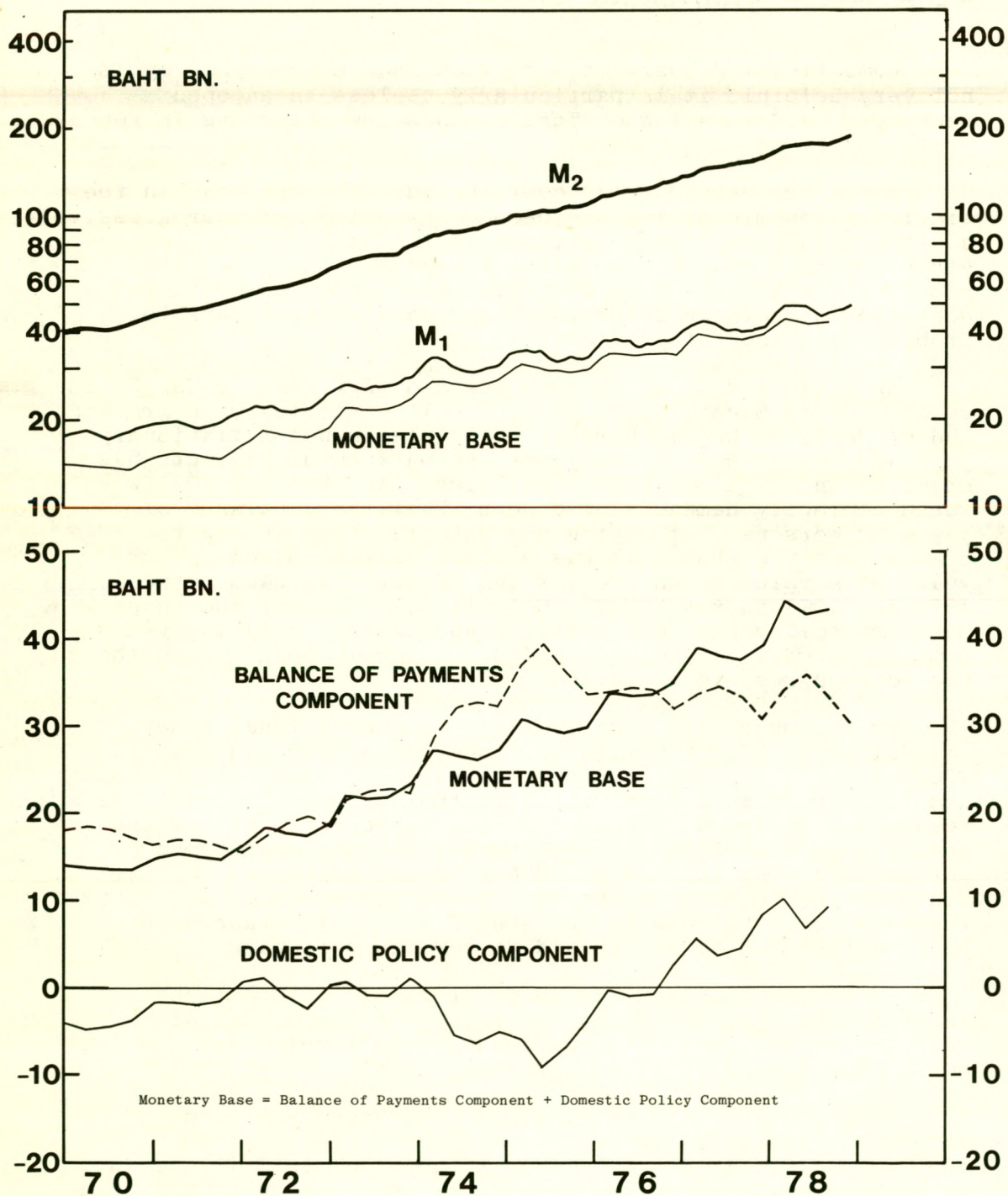
By November last year Thailand's international reserves had fallen to US\$836.6 million, lower than they had been in 1966 and less than half their real value at that time, despite more than 6-fold growth in the value of imports. As a result the reserves fell from a very respectable 91% of the annual import bill in 1965 to 41% in 1975 and down to an estimated 16% by the end of 1978. If the depletion were to continue at the rate of the past three years Thailand's foreign reserves would be gone by the end of 1980. To staunch the outflow the country has turned to foreign borrowing.

Of course Thailand has so far retained an excellent international credit rating - a legacy of the Gladstonian policies of the past, and her accumulated foreign debt is still small even though it is now growing rapidly.

In 1970 the ratio of external government debt and government guaranteed debt to foreign reserves was 41%. At the end of 1975 it was 44%, and at the of of 1977 it was 93%; by late 1978 the ratio was over 200%. Even though the growth has been very rapid in the post-oil crisis years the total official foreign debt in September 1978 was only just over US\$1.7 bn, which is less than a quarter of the Philippine official external debt. Thailand still has an immense amount of 'goodwill' to draw on in order to finance her deficits, but

THAILAND

CHART 2 : MONEY AND MONETARY BASE



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in the meantime changes in macro-economic policy have become imperative. For over a year the government has been attempting to reduce the current account deficit. In early 1978 a package of measures banning various imports and imposing tariffs was introduced and the central bank raised the discount rate. The balance of payments showed no improvement during the year and in fact deteriorated with the result that the overall deficit in the first nine months of 1978 was more than 20% greater than the deficit for the whole of the previous year.

The hike in the discount rate and the accompanying tightening of monetary policy appears to have caused only a temporary hiatus in monetary growth. The year-on-year change in M_2 fell from nearly 21% in January to 17% in August, but M_1 continued to accelerate from under 10% year-on-year to over 17% by November - the highest rate since 1974. The tightening was quite mild and ad hoc import restrictions would have had a doubtful effect while monetary policy remained so relatively expansionary.

One problem with which the monetary authorities had to contend was the deterioration of financial conditions in the U.S.A. Since monetary policy remained expansionary in the U.S. it was very difficult for Thailand to exercise monetary restraint. Because the Baht was closely linked to the US dollar, commercial banks could turn to the US dollar money markets to raise funds without worrying about the exchange risk whenever the Bank of Thailand was being recalcitrant. Conversely when US interest rates rose the Bank of Thailand's discount rate looked more attractive and commercial bank borrowing from the central bank grew, thus, unless the discount rate was raised to keep in line with US rates, Thai monetary policy became automatically more expansionary.

The unpegging of the Baht in March 1978 was the first step in giving Thailand monetary independence but the exchange rate was hardly allowed to move and commercial banks were not forced to make any radical change in policy. Only in November when the Carter measures brought in a new reign of monetary stringency in the U.S.A. was Thailand able effectively to tighten her own monetary policy. When the commercial banks then recoiled from the high Eurodollar rates and turned to the Bank of Thailand they found that the central bank was also tightening its supply of credit to the monetary system. The result was that Thailand experienced a sudden tightening of money markets at exactly the same time as the United States.

The switch from external funding to domestic funding is clearly seen in the balance of payments figures. The repayment of foreign loans and the cessation of new borrowing caused a sharp drop in the non-official capital inflow on the balance of payments and a loss of foreign reserves from the central bank because the Bank of Thailand was supporting the exchange rate.

The sudden tightening of monetary policy also had repercussions for the financial markets. Chart 3 shows the relationship between monetary variables, interest rates and the stock market. Even though the present stockmarket has been active for barely

three years and day-to-day trading is highly speculative and volatile, the traditional relationship between share prices, interest rates and the money supply is beginning to emerge.

As can be seen from the chart, the hike in the discount rate last year was followed by a consolidation phase in the stock market before it resumed its upward momentum. The November developments, however, dealt a body blow. While interest rates rose and the Bank of Thailand looked on, the Book Club index began to tumble from over 220 at the beginning of 1979 down to under 150 in May. The collapse of Raja Finance company is indicative of the severity of the current phase of credit tightening.

Although statistics for the monetary aggregates are not yet available we strongly suspect that a significant slowdown in monetary expansion has at last begun. If so then the strength of domestic demand can be expected to wane during the course of 1979, and inflation will decelerate. While the Baht continues to be managed in line with the US dollar the Thai authorities have little choice but to tighten along with the United States and they will be forced to follow the US business cycle. If they adopt an easier policy, they will find their foreign reserves rapidly dwindling.

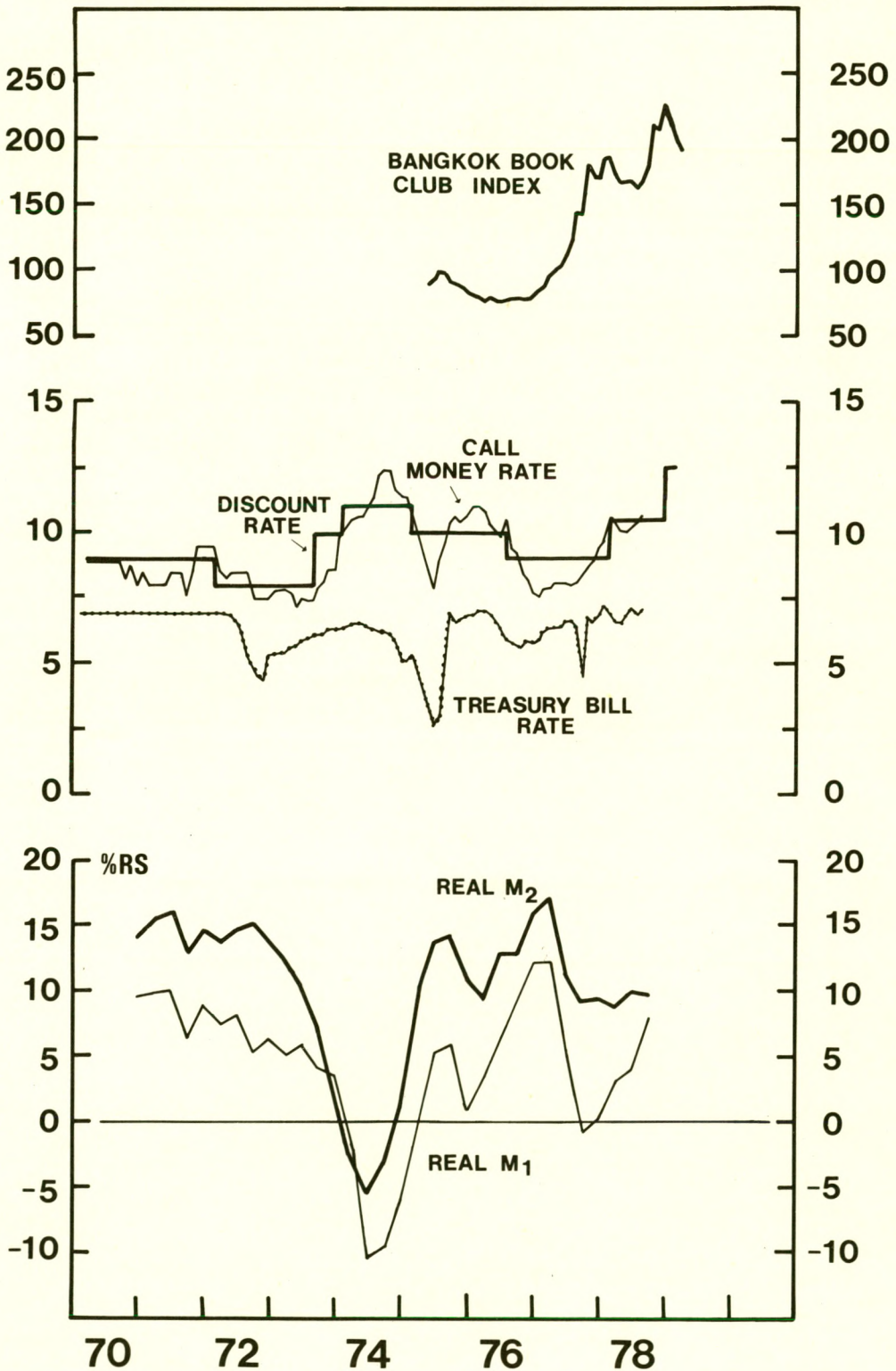
Even if the close link with the dollar did not demand a tight monetary policy, the Bank of Thailand itself clearly wants to restrain credit expansion. When questioned about the prevailing tight money markets in March, Dr. Snoh Unakul, Governor of the Bank of Thailand, attributed the lack of liquidity to high interest rates overseas, the necessity of keeping domestic interest rates high to prevent a loss of foreign currency, and to the seasonal fiscal disbursement pattern of the Thai government. "However" he continued, "don't expect that money will get very loose later in the year, as we have no policy of letting this happen." "We do have a deliberate policy of making money tight."

What are the implications of the restrictive monetary policy for the balance of payments?

Like Malaysia, Thailand's balance of trade was helped during the second half of 1978 and early 1979 by a strong upturn in export prices, rubber and tin in particular. Import prices in contrast were relatively flat. Although the wholesale price indices for imported and exported goods (which reflect these price changes) are far from perfect these trends probably signify an improvement in the terms of trade. This beneficial factor helping the balance of trade was nevertheless overwhelmed by the volume of demand for imports in response to domestic aggregate demand, so the balance of trade and the balance of payments deteriorated in 1978. A more subdued domestic economy in late 1979 is likely to lead to some strengthening of the balance of payments which will be much to the relief of many Thais who have had to put up with increasing bureaucratic impediments to the importation of goods in the past year.

CHART 3 : THAILAND

THE STOCKMARKET AND LIQUIDITY INDICATORS



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As the Bank of Thailand is thus rather constrained it is possible to predict with reasonable confidence that provided the US monetary policy is conservative Thailand will also eventually enjoy falling inflation.

The government can continue to generate inflationary demand if it wishes, but then the exchange rate will have to be supported by increasing foreign borrowing - a policy which is not sustainable in the long run. The major danger to the effective restraint of monetary expansion would be the tendency common to many developing countries of not allowing interest rates to rise sufficiently, thereby encouraging excessive borrowing from the central bank when domestic economic activity is strong.

FORECAST: Financial markets will remain tight until late 1979. Economic activity and inflation will slow down. The Thai economy is closely linked to the US monetary system and developments across the Pacific will be of vital importance to Thailand, so if the USA continues a tight monetary policy Thailand will be compelled to do the same in order to prevent a deterioration in the balance of payments.



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- PHILIPPINES: Staving Off Devaluation

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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

REGIONAL SURVEY

THE EFFECT OF AN OIL PRICE RISE ON PACIFIC RIM COUNTRIES

Since the demise of the Shah of Iran in late 1978 the spot oil price in the Rotterdam market has doubled to reach levels of over US\$30 per barrel. As is often pointed out the volume of oil traded on the Rotterdam market is only a tiny fraction of total world trade in oil - the majority of the world's oil changes hands at regulated prices which are much lower. Nevertheless the fact that the 'free' price is above the regulated price means quite clearly that the OPEC nations are using their oligopoly powers to depress rather than to raise the price of oil to their customers. This phenomenon represents an astonishing and rapid transformation of the role of the price-fixing cartel from the hawkish posture adopted five years ago, and the growing disagreements within OPEC illustrate the textbook observation that cartels are difficult to sustain when free market prices rise above cartel imposed prices.

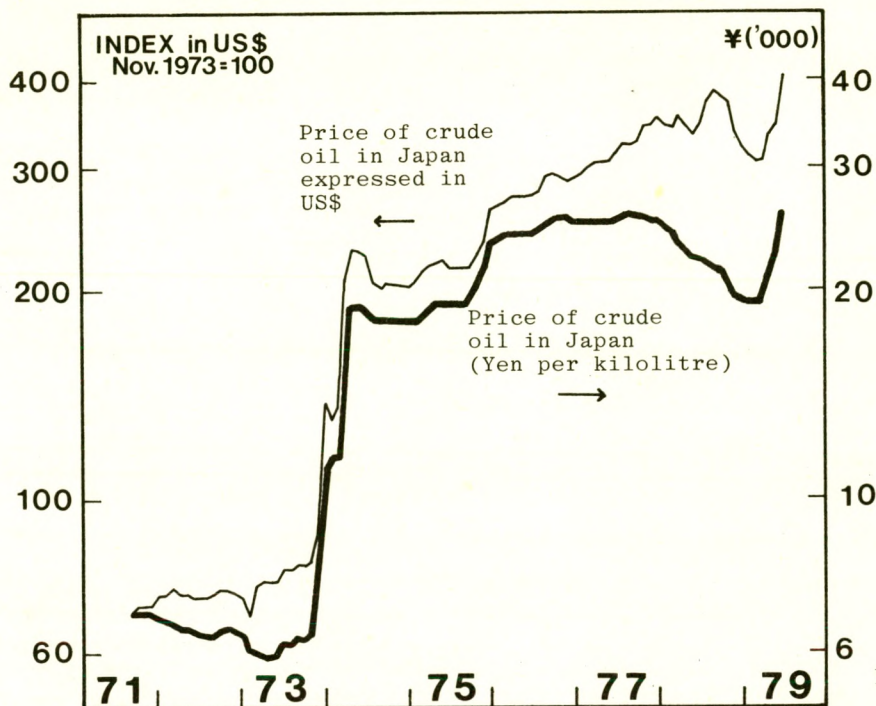
Assuming that countries in the Far East will allow the full effect of the market price of oil to prevail and that they will not step in to regulate the price or quantity of oil available in their domestic markets, can we make any predictions about the effects of the current reduction in the world-wide supply of oil?

OIL PRICES AND INFLATION

That a rise in the price of oil is automatically inflationary is all too often taken to be a self-evident truth. In fact it is false. Inflation will only arise from government policies, not from oil price increases. To see this consider the example of Japan. After the oil crisis of 1973 the Japanese authorities pursued a tight monetary policy which in due course led to an appreciation of the yen which in turn rewarded the Japanese with a dramatic reduction in the price of oil. At the peak exchange rate of under 180 yen to the dollar in October 1978, the import price of oil in Japan had fallen nearly 30% since 1976. Nearly half of the total increase in the dollar price of oil since 1972 had been eliminated by the consequences of the Japanese monetary policy. (See Chart.)

Few countries in the world followed the same course as Japan, and no other country in the region enjoyed the same reduction in the nominal price of oil, but the Japanese example demonstrates the fact that the nominal increase in oil prices can in theory be eliminated by following a monetary policy which generates an appreciating foreign exchange rate. Such a policy in no way reduces the deflationary effects of oil price rises, which are the consequences of a transfer of wealth from the oil consumer to the oil producer, but it does prevent oil price hikes having an effect on the overall nominal price level within a country. Inflation, as always, is a consequence of monetary policy; it is not caused by the OPEC cartel. Some countries in the region will suffer from high inflation rates in 1980 but none can blame oil prices for their problems.

THE PRICE OF OIL IN JAPAN



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OIL PRICES AND THE ECONOMIC STRUCTURE

The disruption to economic activity caused by an oil price increase arises from a change in the pattern of supply and demand caused by a large shift in purchasing power to the oil producers. If the oil producers have a higher propensity to buy gold than oil consumers, the demand for gold will rise and the demand for other goods will decline - which means that all the capital invested in the production of other goods except gold (and oil) will show a lower return than before. If the pattern of demand of the oil producers were the same as the pattern of demand of the oil consumers a transfer of wealth from one group to the other would lead to less disruption - and the existing capital would continue to serve the demands of the world profitably. The disruption of economic activity arises from a sudden change in the pattern of demand which causes an overall drop in the demand for the output of most of the existing capital structure, but this is nothing to do with currencies or balance of payments problems.

A country which neither imports nor exports oil can be just as badly affected as a country which is entirely dependent on oil imports.

The curious example of Mangoland illustrates this fact. This small Pacific island group, you will recall, imports only Japanese television sets and exports only mangoes. The electricity necessary to run the T.V. transmitter and the T.V.

sets is generated from the hot water provided by the many geothermal springs with which bountiful nature has endowed the islands. The natives have no need of cars and other petrol driven machinery so that Mangoland astonishingly is one of the few countries in the world which does not depend on the black fluid for its way of life.

When recently the price of oil suddenly doubled the elected King, Fructose IX, in his triannual speech to parliament boasted that, thanks to the virtuous abstinence of his people, his country would continue its march of progress gloriously unaffected by the world energy crisis.

Alas he was mistaken. The world price of mangoes collapsed. The reason was that non-oil producers (particularly the Japanese) were forced to spend less on other goods and services in order to pay more for oil. The reduced demand for mangoes was not offset by higher demand from the oil producers who preferred to invest their fortunes in assets other than fruit.

The crucial factor in considering the effect of oil price increases on companies, industries or countries is therefore their capital structure. If their capital is heavily invested in the production of goods which will be in less demand they will obviously suffer a setback. Conversely, if their capital is heavily invested in oil or oil substitutes or goods and services demanded by oil producers, they may even benefit. A prime example in the second category is Malaysia which not only produces oil but also produces natural rubber, a valuable substitute for oil-based synthetic rubber. Korea benefits in the third way by providing construction workers and facilities to Middle East countries whose demand for infrastructure development projects has boomed.

THE PROCESS OF ADAPTING TO HIGHER OIL PRICES

A secondary, but in the longer run very important consideration is the rate of growth and replacement of the capital structure of an economy.

Capital investment planned and implemented after the price of oil increased in 1973-74 will be on average more profitable than capital investment which was designed to be profitable in the earlier years of cheap energy. The increase in oil prices has shifted investment incentives towards the utilization of alternative energy sources and made oil-consuming activities less rewarding, and capital investment plans have changed in response.

The more rapidly the capital stock is expanded and replaced the more rapidly an economy can be expected to recover from the oil shock. In this respect most of the countries in the Asian Pacific region have an advantage over other countries simply because they are among the most dynamic and fastest growing economies in the world.

As a rough estimate and using some heroic assumptions, 27% of the existing capital stock in Japan was installed after 1973.* On a similar basis estimates for some other countries in the region are set out below:

	Estimated percentage of capital stock which was created after 1973	Annualized rate of growth of GNP 1973-78
Korea	55	10.2
Hong Kong	42	8.6
Singapore	41	8.2
Taiwan	40	7.1
Japan	27	3.6

The fastest growing economy, Korea, has produced over half its existing capital stock since 1973, while Taiwan, Singapore and Hong Kong have all produced over 40% of their capital since 1973. In the future these fast growing economies can be expected to be especially resilient to changes in resource prices. In the short term they may be quite adversely affected, but as long as they continue to have high savings and investment rates they will display an enviable adaptability. Hong Kong in particular would appear to be among the most vulnerable of territories to an increase in energy costs having no natural resources of its own, but its rapid underlying growth rate and the freedom of the private sector to invest as it chooses in response to international price movements makes it well able to overcome any sudden external shocks.

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- * 1. Assume the capital stock is proportional to GNP.
2. Real GNP in Japan increased 19.6% in the period 1973-78, therefore the capital stock increased by 19.6%.
3. From E.P.A. National Income statistics it can be calculated that (between 1972 and 1976) 'Provision for the consumption of Fixed Capital' was equal to an average 39% of 'Gross Domestic Fixed Capital Formation'.
4. From 2 and 3, the growth of the capital stock in 1973-78 derived from 61% of GDPC.
5. $(19.6 \times \frac{100}{61}) \div 119.6 = 27\%$ of the capital structure of Japan was created after 1973.

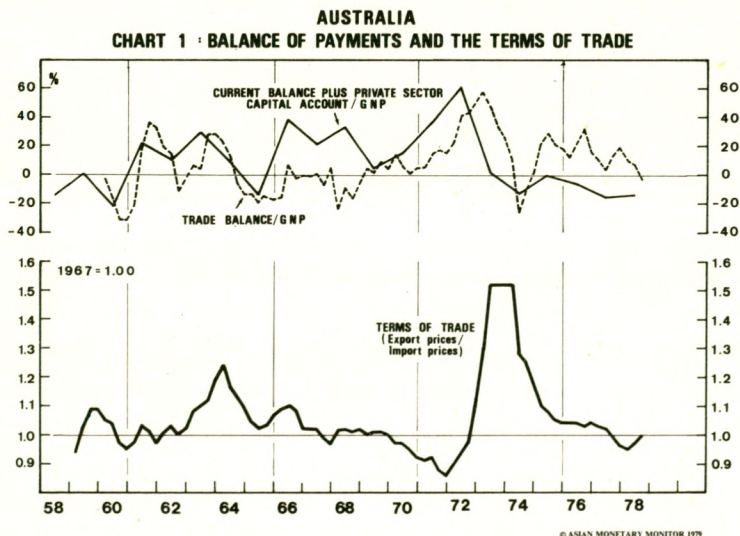
AUSTRALIA

RETURNING TO A COMPETITIVE EXCHANGE RATE

In the first half of 1979 the Australian international balance of payments showed considerable improvement compared with a year earlier. Exports in particular recovered rapidly; in the first five months of 1979 exports were up 28% on the same period in 1978. After several years of an apparently chronic weakness in the external account the present recovery is welcome, but it is worth trying to examine why the recovery has occurred and to assess whether the recovery is sustainable.

The government's policy towards the balance of payments has been ambivalent. On the one hand the government has borrowed overseas to support the exchange rate, while on the other hand it has allowed the A\$ to depreciate against all but the weakest currencies in the past two years. The official justification for the support of the exchange rate was apparently that it was merely a temporary measure to prevent a destabilizing depreciation of the currency and its accompanying effect on inflation expectations. The foreign borrowing provided a temporary bridge until such time as the government's macro-economic policy brought about a strengthening of the balance of payments. A combination of both domestic policies and exchange rate management were to restore external equilibrium and the exchange rate was not to bear the brunt of adjustment alone.

The policy has been one of moderation in all things; a moderate restraint of the money supply, a gradual reduction in the budget deficit, a moderate decline in the A\$, and a moderate reduction in inflation. The results have also been moderate. Indeed some of the more cynical Australian observers have even suggested that the trend towards improvement has been so moderate that it has stopped and reversed direction.



Have the government's policies resulted in a substantial improvement in Australia's competitiveness? How much can the recent improvement in the current balance be attributed to government policy and how much to the fortuitous intervention of the weather and commodity prices? How much of the improvement can be attributed to internal policies (monetary and fiscal policies) and how much to external factors such as exchange rate movements and inflation overseas?

An examination of the terms of trade (the export price index divided by the import price index) shows that the deterioration in the balance of payments cannot be blamed on a fall in the terms of trade (see Chart 1). It is true that the terms of trade have declined by an enormous 33% since 1974, which would certainly have weakened the trade balance since that year, but in historical context the terms of trade in 1973-74 were distorted dramatically in Australia's favour. Compared with the 1960s the terms of trade today are not depressed. In fact the trade balance itself has not been notably weak in the past three years (see Chart 1). Following the depression of 1974 the trade balance expressed as a percentage of GNP has been remarkably buoyant especially in comparison with the late sixties. The big change has been in the other components of the balance of payments, the services account and the private sector capital account - which only serves to emphasise the importance of considering the balance of payments as a whole. Monetary policy, inflation and exchange rate movements are probably the dominant influences on the external account, affecting as they do both trade and capital movements.

In attempting to measure the effects of these macro-economic factors, it is useful to have some measure of competitiveness.

A traditional measure of international competitiveness is the Purchasing Power Parity Index which is defined as the ratio of prices in Australia to prices in a foreign country adjusted for exchange rate movements.

$$\frac{\text{Australian prices}}{\text{Foreign prices}} \times \text{Exchange rate (A\$ per unit of foreign currency)}$$

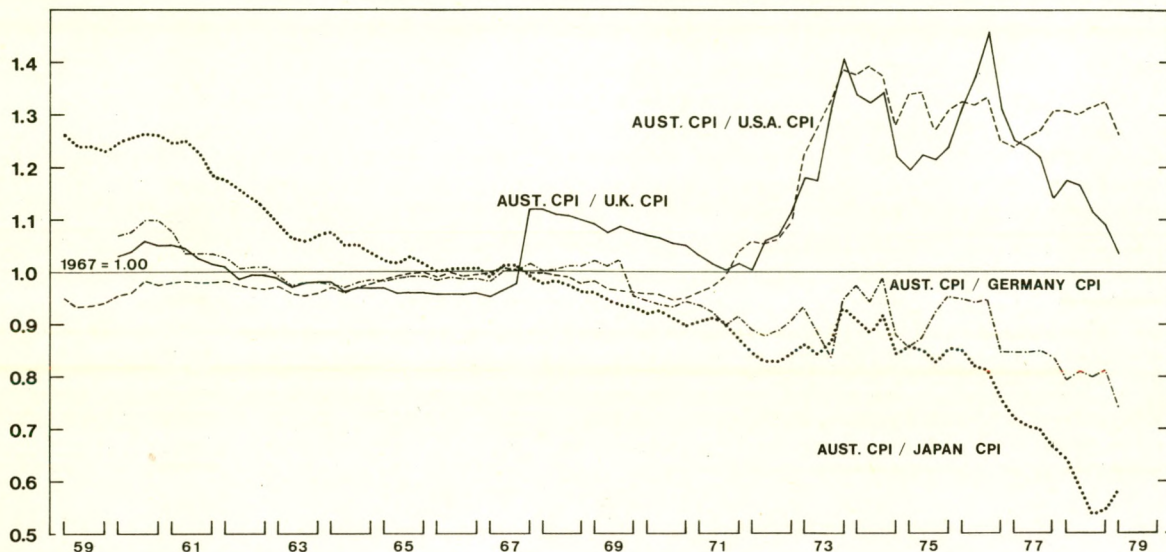
The higher this index is, the less competitive Australian goods are in comparison with foreign goods. In other words it is a loose measure of how 'over-priced' Australian goods are.

Two things should be noted. Firstly, the value of the index is unimportant as it depends arbitrarily on which base date is used. The index should therefore only be used as an indicator of trends. Secondly, as we shall show, the index looks radically different depending on which price-indices are used in its calculation.

Because Australia no longer produces a comprehensive wholesale price index most commentators have contented themselves with Purchasing Power Parity Indices (PPPI) calculated using consumer prices instead. In fact, consumer prices are not very suitable for the job because they are prone to distortion from

sales tax changes and because they include distribution costs and retailers margins which are not included in the f.o.b. export prices of goods. Distribution costs generally rise relative to producer prices because productivity in the tertiary sector improves less rapidly than in manufacturing. These factors tend to bias the PPPI index so that high productivity growth countries appear less competitive than they may actually be.

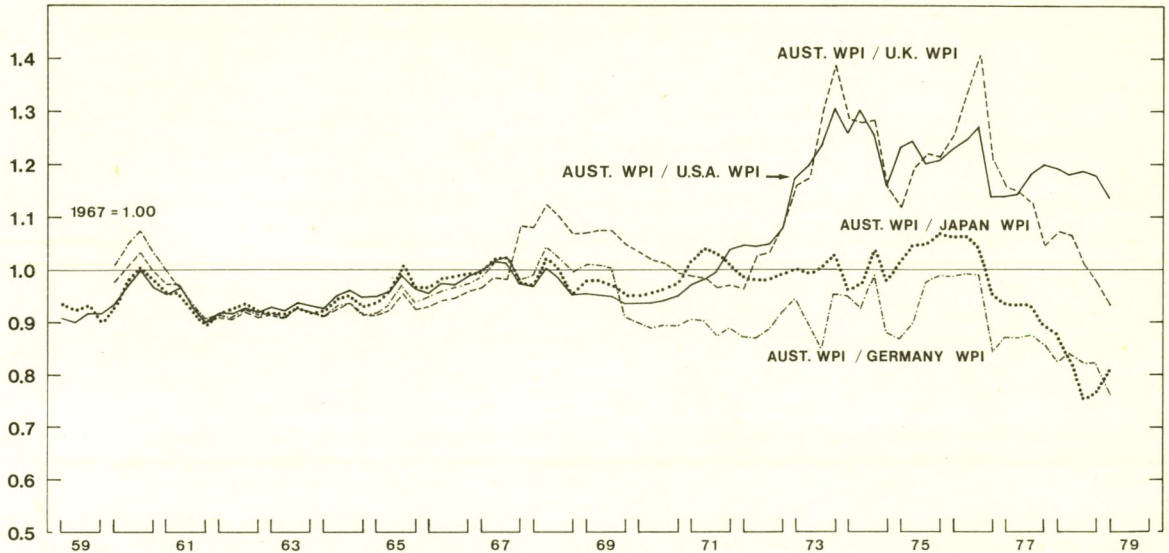
CHART 2
AUSTRALIA: PURCHASING POWER PARITY INDEX



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Chart 2 shows this effect clearly. In order of productivity growth in manufacturing, Japan, Germany and the US show progressively greater competitiveness against Australia. The UK parallels the US in this respect until 1977 when the relationship between exchange rate movements and inflation rates in the UK altered (perhaps because of North Sea oil production). Put another way, Australia appears to have grown less competitive relative to the US since 1970 whereas it appears to have been improving in competitiveness relative to Germany and even more so relative to Japan. However, international trade is not conducted at the retail level but at the producer level and the fact that productivity has improved only very slowly in the retail and distribution system of Japan is almost irrelevant to the competitiveness of her goods overseas or the competitiveness of foreign imports (which must in any case also go through similar distribution arrangements within Japan). The dramatic reduction in unit costs which has characterised Japanese manufacturing in the past twenty years has meant that wholesale prices have risen very much less. As we shall see, as measured by wholesale prices, Australia's impressive gains in competitiveness evaporate for all but the last three years.

CHART 3
AUSTRALIA: PURCHASING POWER PARITY INDEX



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The wholesale price index for Australia used in calculating the Purchasing Power Parity indices in this chart was derived from the general wholesale price index available until 1976 and the wholesale price index of materials used in house building thereafter.

Of the four indices considered here only two - the USA and UK indices - show a marked deterioration in Australia's competitiveness in 1972-3. Were we to judge from the Japanese and German indices alone, the weakness in Australia's balance of payments in the past 4 years would be difficult to explain for they show no such deterioration. Other work on PPPI's for Japan against the USA and against other countries also suggests that the shift in the terms of trade, and the rapid transformation of the structure of Japan's economy have made PPPI exercises using Japanese data untenable if extended back for more than, say, six years. All of which implies that the trend over recent years in the PPPI is a valid indicator but comparisons with pre 1972-3 data should be made with caution. In other words, the fact that the Japanese data does not show a marked deterioration in Australia's position in 1972-3 is not particularly convincing evidence that Australia did not in fact become less competitive vis a vis Japan in that period. Germany is less easy to reconcile but we suspect similar considerations prevail.

All four indices show that the advantage gained by the 1974 devaluation of the A\$ was rapidly eroded by inflation, but that the second devaluation in 1976 did however 'stick'. Similarly all four indices show a trend towards improved Australian competitiveness has occurred since 1976. Nevertheless the USA

index still remains higher than it was in the 1960s, implying that despite the improvement so far Australia still has further to go towards restoring her competitiveness relative to that country.

To what can we attribute the improvement in competitiveness which has occurred in the past two years? Surprisingly, in the light of the government's professed aims, the gain has come about almost entirely through external adjustments rather than internal policy. (See box below.)

The external factors in this case were a combination the depreciation of the A\$ and the acceleration of inflation overseas. The internal factors, monetary policy and domestic inflation have shown either no improvement or even a deterioration. Moreover the depreciation of the A\$ has occurred despite official foreign borrowing.

Table 1

The Contribution of Internal and External factors to the improvement in Australia's Competitive position

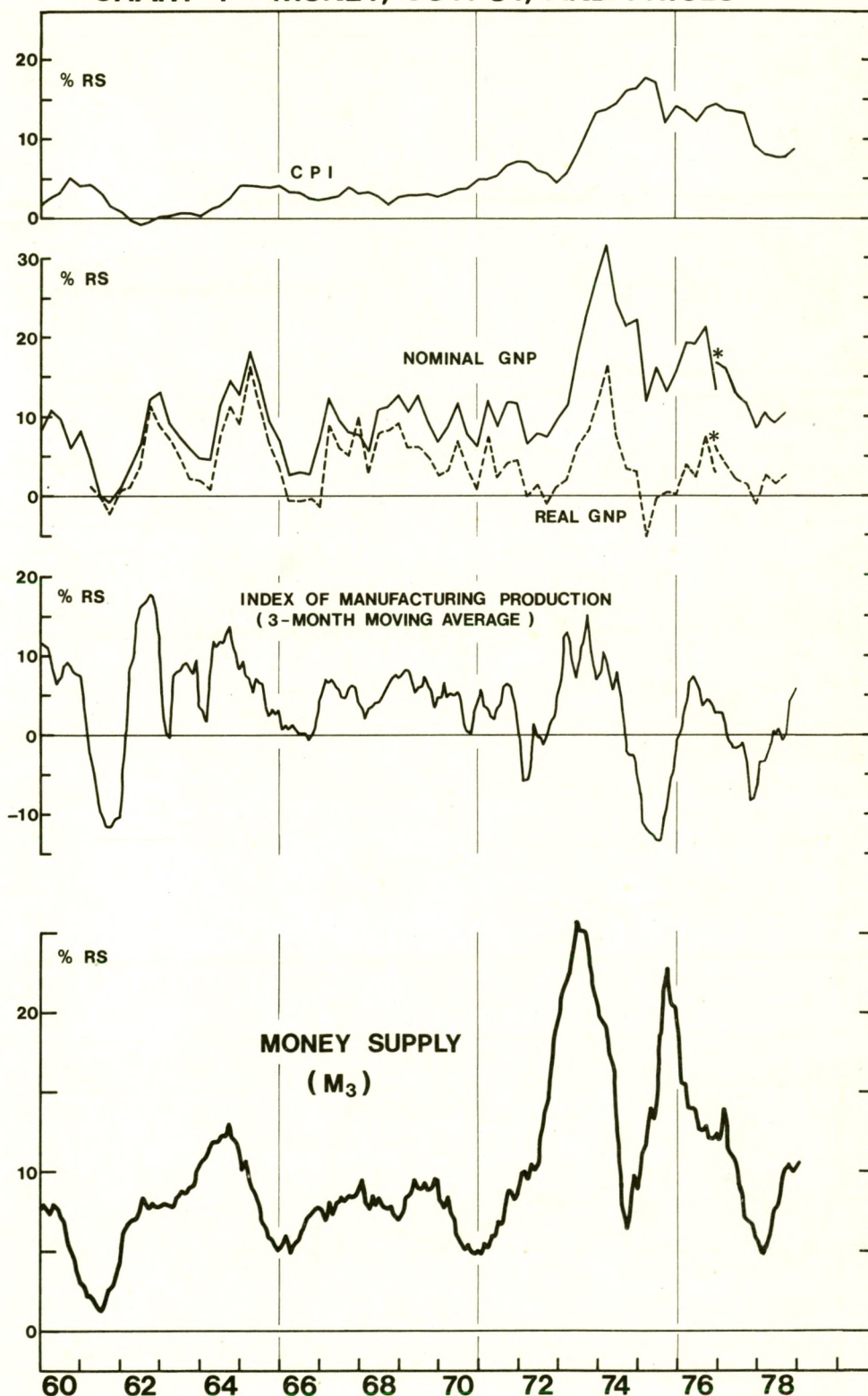
<u>Relative to:-</u>	USA	UK	Germany	Japan
(a) <u>Domestic Policy</u> change in Australian Price Level	+18.1	+18.1	+18.1	+18.1
(b) <u>Overseas Policy</u> change in Foreign Price Level	+20.1	+28.5	+ 5.1	- 2.1
(c) Net effect of relative inflation rate on competi- tiveness	+ 1.7	+ 8.8	-11.0	-17.1
(d) <u>Exchange Rate</u> <u>Effects</u>	- 1.7	+19.5	+26.2	+41.7
(e) Total change in PPP advantage	0	+30.0	+12.5	+17.6

Table 1 analyses the component contributions to the improvement in Australia's Purchasing Power Parity position between the final quarter of calendar 1976 and the first quarter of 1979.

Row (a) shows that wholesale prices in Australia rose by 18.1% in the period concerned and row (b) shows the increase in wholesale prices overseas. The Australian price increase

AUSTRALIA

CHART 4 : MONEY, OUTPUT, AND PRICES

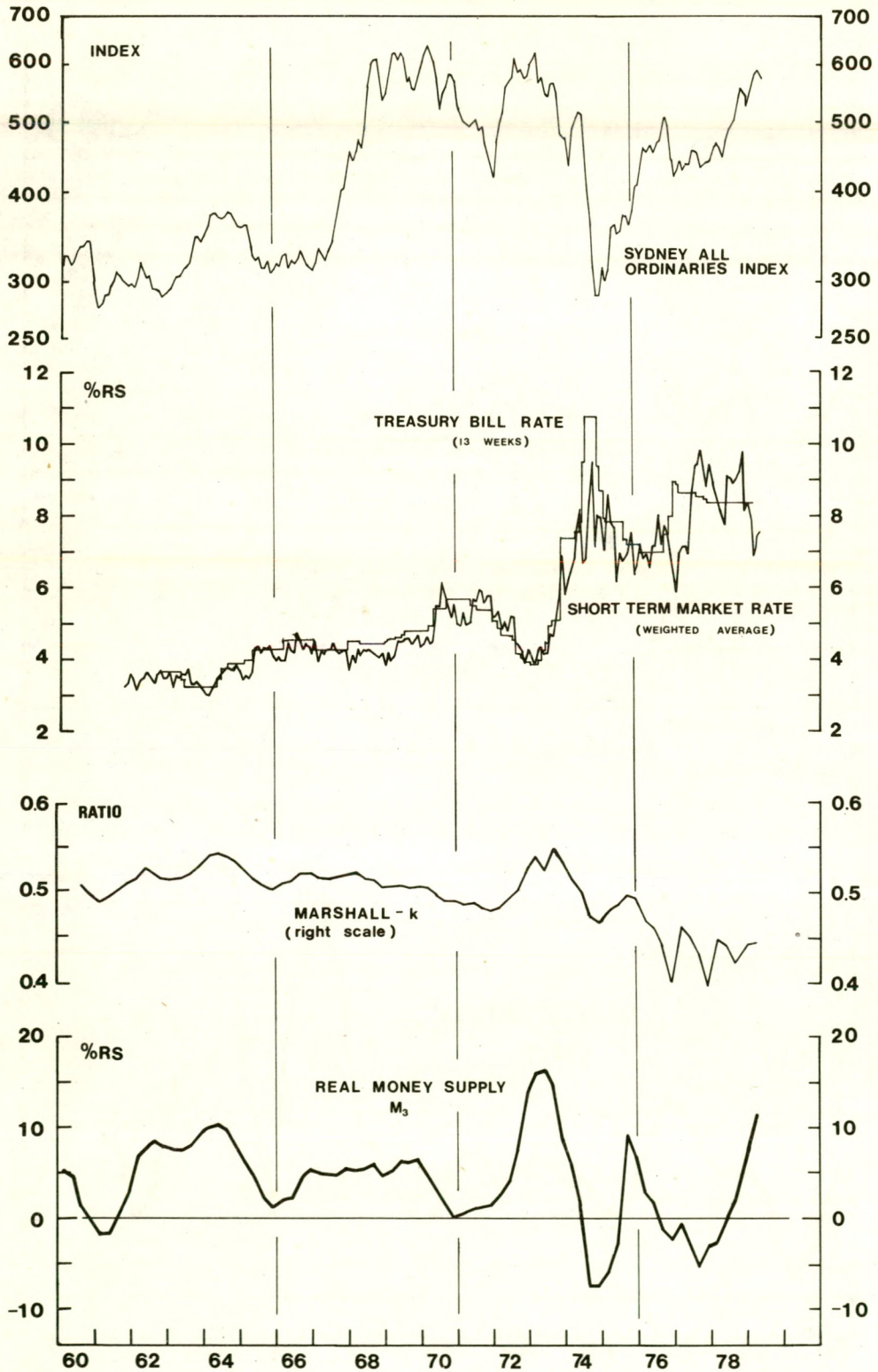


*Change of data series.

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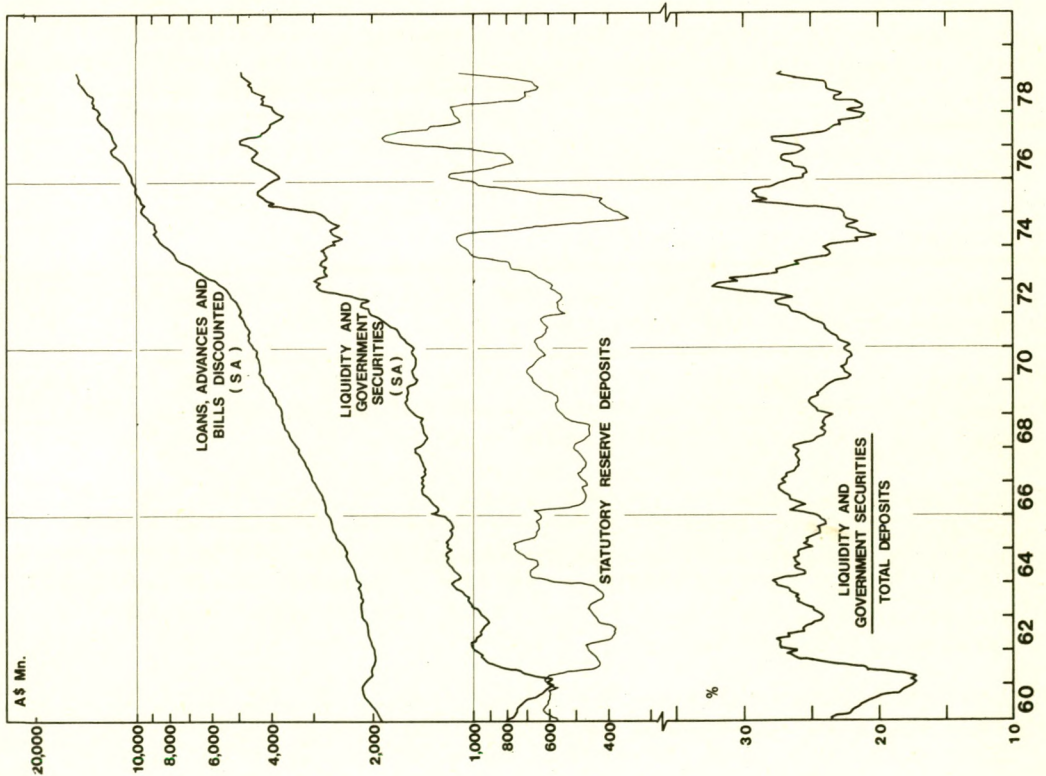
AUSTRALIA

CHART 5 : THE STOCKMARKET AND LIQUIDITY INDICATORS

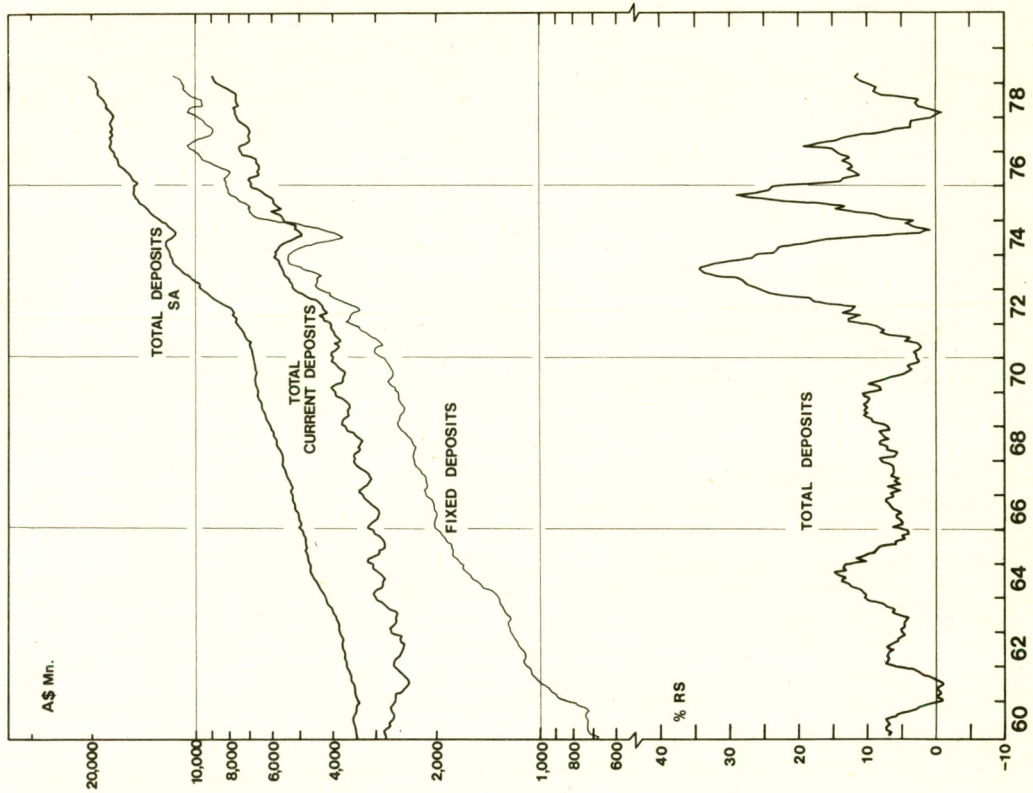


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AUSTRALIA
CHART 6 : BANK ASSETS
(MAJOR TRADING BANKS)



AUSTRALIA
CHART 7 : BANK LIABILITIES
(MAJOR TRADING BANKS)



was greater than in Germany and Japan but marginally less than in the USA and much less than in the UK. The net effect on the relative price level is shown in row (c) which shows that if exchange rates had been fixed then the inflation which took place in each country would have caused prices in the USA for instance to rise 1.7% relative to prices in Australia, but prices in Japan would have fallen 17.1% relative to prices in Australia. Loosely row (c) can be considered to measure the relative success of Australian domestic economic policy in fighting inflation compared with the achievements of foreign countries. By this measure Australia gained only marginally against the US, gained substantially relative to the UK but lost ground considerably against Japan and Germany.

Row (d) saves the day for Australia. The Australian dollar fell in value against three of the four other currencies and gained only minimally against the fourth, the US dollar. Notice that the competitive advantage gained in row (d), the exchange rate effect, outweighs the effects of row (c) so that even though her inflation performance is mediocre relative to the other four currencies, the large devaluation of the A\$ against all but the US dollar gave Australia large gains in her competitiveness (row (e)).

In other words - the brunt of the adjustment was in the exchange rate: improvement in the domestic inflation performance played only a secondary role.

The implications for future policy are serious. Unless greater headway is made in bringing down inflation, Australia will have to continue to rely on a falling exchange rate to maintain her competitiveness, or alternatively to hope for an acceleration in inflation in other countries. The current optimism about the balance of payments does not derive from an improvement in 'internal' economic policy so much as from the very large devaluation of the Australian dollar against most major currencies in the world in the past two years.

In summary:

- 1) Australia has enjoyed some improvement in competitiveness as measured by her Purchasing Power Parity.
- 2) The improvement has been mainly due to the large fall in the exchange rate, and the lower inflation rate in Australia has played only a minor role.
- 3) The weak balance of payments cannot be explained by the change in the terms of trade or indeed by a weak trade balance. Similarly an improvement in the trade balance whether due to the weather or the terms of trade need not necessarily produce a sustainable improvement in the balance of payments.
- 4) Unless top priority is given to reducing the rate of inflation by following an appropriate monetary policy, Australia may have to resort to further depreciation of the external value of her currency in the years to come in order to maintain her competitiveness in international markets.

HONG KONG

AN ILLUSORY SQUEEZE

The behaviour of interest rates in Hong Kong in the past year has caused a great deal of concern in the financial community. A glance at Chart 2 shows that the present level of interest rates and their rapid rise is extraordinary even when compared with the 1973-74 episode, yet the banking system is, according to many observers, still liquid. Why have rates risen and what are the effects on the Hong Kong economy?

One argument is that the prime lending rate has been manipulated by the Exchange Banks Association to artificially high levels in response to government pressure in an attempt to restrain bank credit expansion. The interest rate structure is seen as almost the only tool the government can use to regulate 'credit' given their reluctance to peg the exchange rate. But, it is claimed, the use of interest rate controls in pursuit of government aims has now been pushed to the extreme where banks can clearly see that their 'social responsibility' is in conflict with their duty to their shareholders. Apparently many banks have the funds to lend but feel that it is their public duty not to lend them - a situation which is a disservice to their shareholders and hardly conducive to the development of an efficient and competitive banking system. An acrimonious air has been added to the whole affair by the foreign banks who are accustomed to borrowing heavily on the local interbank money market to fund their lending in Hong Kong. Some of the foreign banks have made accusations that local interest rates are being manipulated by the large local banks to starve the foreign competitors of funds.

Overall the existence of the interest rate fixing cartel (the Exchange Banks Association), the suspicion of government intervention and the alienation of the foreign banks create a thoroughly unsatisfactory environment of unnecessary uncertainty. Perhaps worst of all there is no a priori way of knowing whether the artificial setting of interest rates will have the desired effect of cooling down the economy.

The effect of raising the best lending rate

The best lending rate of the Hong Kong and Shanghai Banking Corporation is taken as a bench mark by the members of the Exchange Banks Association. Rarely have they lent at rates lower than the HSBC Best Rate and usually they have lent at or above the rate. In the past year progressive increases in the 'prime' rate (the best lending rate) have occurred in the hope that this will slow down bank lending and credit expansion in general. Many people have accepted the logic behind this line of reasoning without question, but it is as well to point out that the relationship between interest rates and monetary policy in Hong Kong is very different from elsewhere - and the simple relationships widely recognised in a central bank

monetary system are not self-evident in Hong Kong.

Under a central bank system the key interest rate is the rate at which the commercial banks can borrow reserves from the central bank. In the USA and Japan it is the discount rate in the UK it is the Minimum Lending Rate. Consider for a moment the US system which is the easiest to understand; the initial effect of an increase in the discount rate is to make it more expensive for commercial banks to obtain reserve cash from the central bank, so they reduce their demand for reserves. Since in the US system the banks have to maintain a fixed ratio between their deposit liabilities and their reserves, the reduced availability of reserves restrains the growth of deposits. Because the banks find borrowing from the central bank more expensive they turn to other sources of funds, for instance, they sell bonds or reduce their loans in an attempt to raise cash from the non-banking sector. Cutting back on loans and selling bonds bids up interest rates throughout the financial system, bank lending rates rise and bond prices fall. Monetary expansion is restrained because the hike in the discount rate reduces the monetary base (bank reserves plus currency in circulation outside banks), and the rise in bank lending rates is a secondary symptom of the tightening: the primary cause of tightening is the shortage of bank reserves.

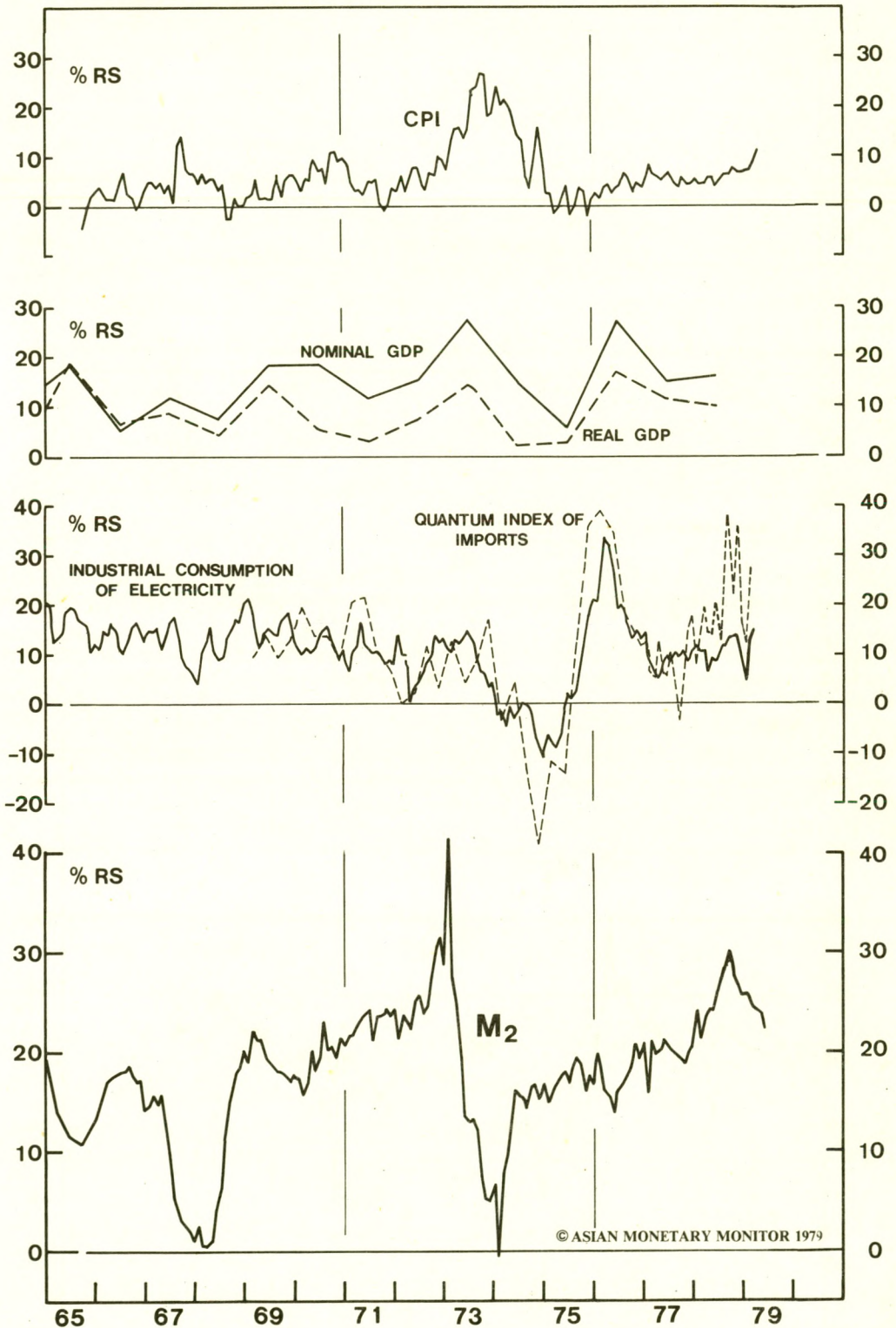
If for some reason the supply of reserves was undiminished despite the increase in the discount rate (for instance if reserves were supplied through a government budget deficit financed by printing money) the credit expansion would continue regardless of discount rate changes. The hike in the interest rate is thus not essential but the restriction of the growth of reserves is.

Turning to the Hong Kong financial structure, the difficulties of the present policy are clear. To use a hike in the prime lending rate of the banks as a tool to reduce credit expansion is to concentrate on the wrong end of the causal chain. Commercial Bank lending rates should be only a symptom and not a cause of monetary restraint. The primary cause of monetary restraint should come from a restriction of reserves and when reserves are not controlled then tightening using a few 'key' commercial bank interest rates is unlikely to succeed. If the financial system in Hong Kong continues to have access to cheap abundant reserves, then the enforcement of a high lending rate by the banks will only cause distortions to bank balance sheets. Moreover it will encourage the growth of credit instruments and financial institutions outside the ambit of the Exchange Banks Association which can circumvent the controlled interest rates, rendering the EBA impotent in its attempts to hold back credit expansion.

The restriction of monetary expansion obtained by a control of the quantity of reserves is especially effective because it reduces the availability of liquid assets to all sectors of the financial community. The banks can only offset their shortage of reserves by bidding for liquid assets from other institutions. The other institutions in their

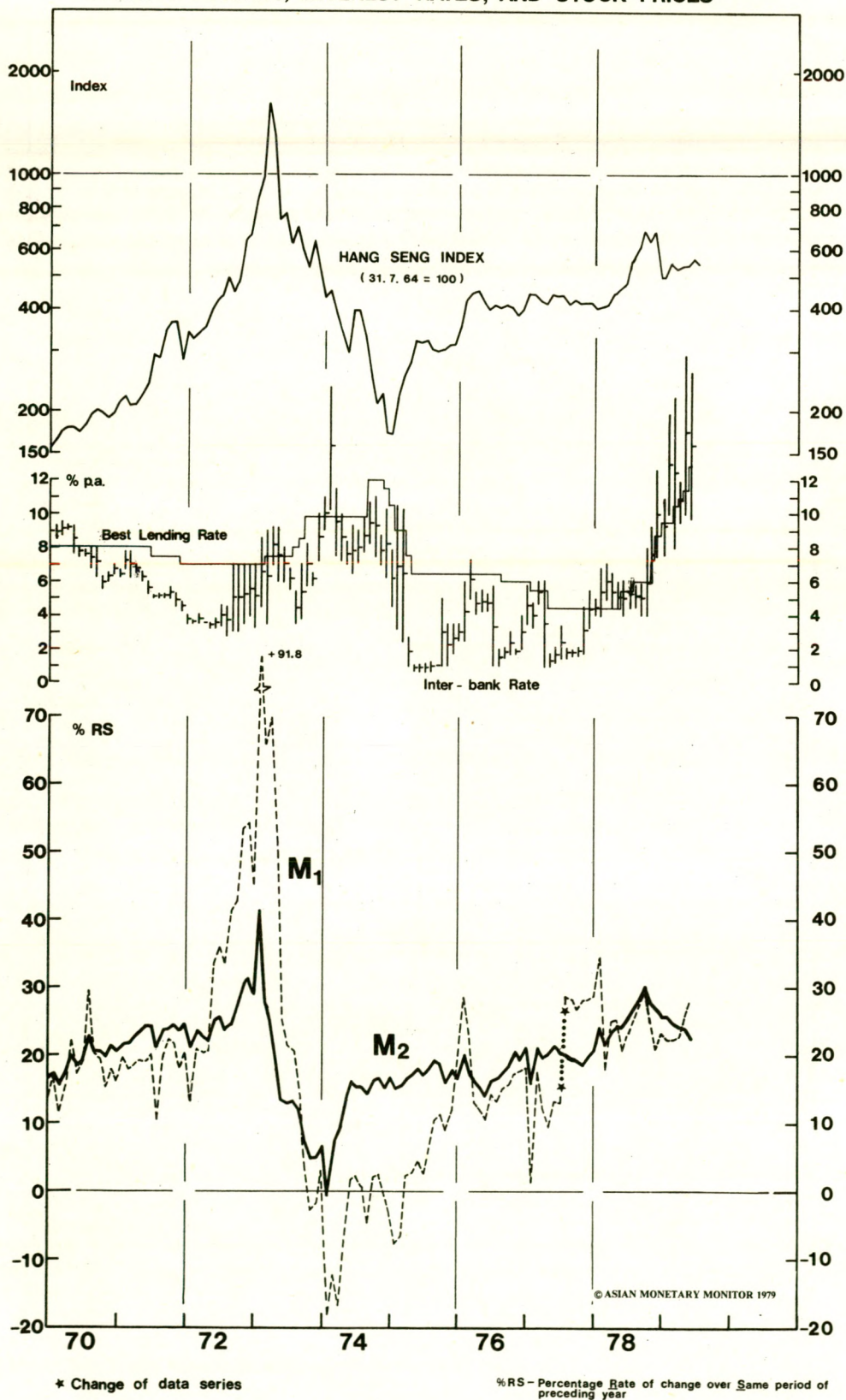
HONG KONG

CHART 1 : MONEY, OUTPUT INDICATORS, AND PRICES



%RS - Percentage Rate of change over Same period of preceding year

HONG KONG
CHART 2 : MONEY, INTEREST RATES, AND STOCK PRICES



* Change of data series

%RS - Percentage Rate of change over Same period of preceding year

turn are forced to reduce credit extension. With the supply of reserve assets thus constricted an expansion of credit by one institution can only be at the expense of another, and the total amount of credit extended in the economy is unable to expand as much as it otherwise could. In response to the general constriction in the supply of reserves, interest rates throughout the financial system rise, and bank lending rates are not forced to be the sole focus of the restraint.

It is rather like forcing a woman into a corset to reduce her waistline while continuing to allow her to eat as much as she likes. Eventually as she continues to get fatter the corset will become so uncomfortable that she will make every effort to take it off. Obviously the better way to make her slim would be to reduce her food intake - then she would not even need the corset.

There may be some signs that the lady is struggling to get out of the corset already. In an unusual move some banks are undercutting the prime rate on loans to special categories "in order to help our external trade". One might also add that it enables the banks to expand their loans and reduce their excess liquidity thereby defeating the purpose of the restraint.

Further indications of discomfort are the recent developments in the balance sheets of deposit taking companies (DTC's). As part of the credit restraining strategy the interest rates paid on deposits at the banks have been raised more slowly than the lending rates - the idea presumably being that low deposit rates discourage the growth of deposits (which form the major proportion of the monetary statistics M_1 and M_2) while high lending rates discourage further loan growth. The result not surprisingly is that depositors have withdrawn their deposits from the banks and have taken the money round the corner to the DTC's who pay more generous interest rates. Since many of the finance companies are subsidiaries and affiliates of the banks, they have found it amicable and profitable to lend the money straight back to the banks in the interbank market. Thus a glance at the bank balance sheets shows the slowdown in the growth of deposits at the banks (which is the major reason for the slowdown in the money supply), but the growth of domestic loans and advances has continued virtually unabated and deposits at the DTC's have been growing explosively.

The much publicised deceleration of the monetary expansion in the past six months may thus be an illusion created by the partial coverage of the official banking statistics.

The artificial fixing of interest rates in one part of the financial system, while the supply of reserves to the system as a whole has continued to grow, has merely shifted the asset/liability structure to the advantage of the unregulated institutions, and the total amount of credit expansion appears to have been hardly affected.

An examination of the available statistics prompts the question:

If the bank lending rates have really been raised above 'market' levels in an attempt to restrain credit, why is it that bank lending rather than DTC lending has continued to grow strongly?

Table 1

The Growth of Deposits and Lending in Hong Kong

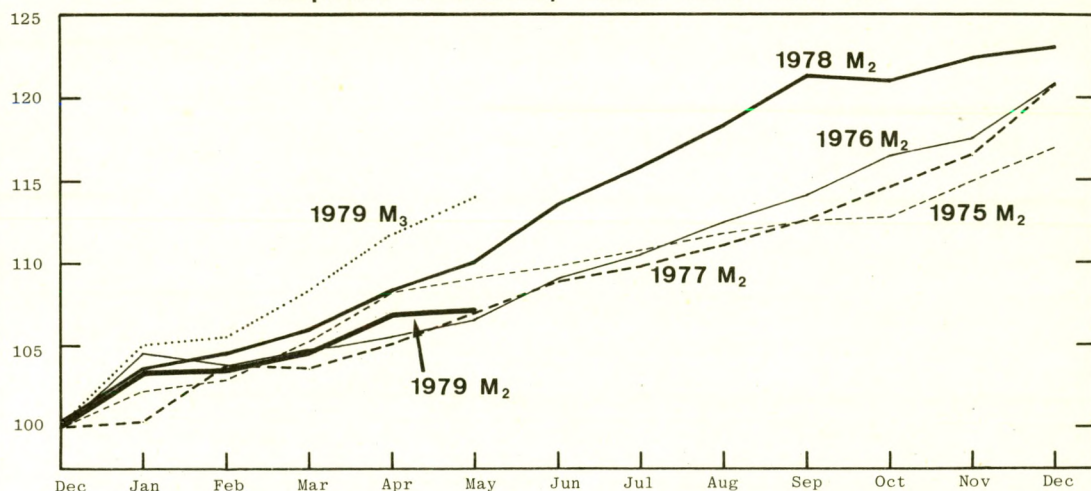
HK\$ million			
<u>Deposits</u>	<u>Banks</u>	<u>Deposit Taking Companies</u>	<u>Total</u>
Dec 1978	66,858	10,447	77,305
May 1979	72,020	16,964	88,984
% increase	7.7% (10.5%)*	62.4%	15.1%
<u>Loans & Advances</u>			
<u>in Hong Kong</u>			
Dec 1978	52,814	10,113	62,927
May 1979	60,640	10,604	71,244
% increase	14.8% (12.6%)	4.9%	13.2%

Note: It is not possible to tell whether there is some double accounting in the official statistics. For instance some of the DTCs may hold deposits with the banks so that the strict total of non-financial sector deposits with the financial sector may not be as large as the Total shown here.

* Figures in brackets refer to the increase over the same period of the previous year if available.

If banks were really charging punitively high loan rates, surely they would be losing loan business to the DTC's? In fact the reverse appears to be the case: bank lending is growing strongly but DTC lending is stagnating. The conclusion must be that the bank lending rates are at or near the 'market' level - and not punitively high as alleged. In other words credit is not being rationed. Which leads us to the question; why are the 'market' rates of interest so high? Why is loan demand still so high at a 13% best lending rate? The answer is inflation. The demand for loans depends on the rate of interest charged, the level and nature of activity in the economy (whether the economy is depressed on booming) and on the expected rate of inflation. If the Hong Kong dollar is perceived to be a weak currency with a fast diminishing purchasing power the loan demand will be stronger at a given rate of interest than if the Hong Kong dollar had a stable purchasing power. In other words the 'perceived real rate of interest' is probably more important than the nominal rate. Thus even though the prime has been hiked from 4.75% in April 1978 to 13% today, loan demand may be growing just as rapidly as before because inflation expectations have risen so much.

CHART 3
Comparison of Monetary Growth Rates since 1975



'M₃' equals M₂ plus deposits of DTC's minus DTC's holdings of cash.

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The money supply M₂ has shown an accelerating trend since the recession of 1975 until September 1978. Since then M₂ has grown at a slower rate but the newly available DTC deposit² statistics enable an 'M₃' to be compiled which was growing at an annualized rate of over 40% in the first five months of 1979.

Table 2

Domestic Loans and Advances by the Commercial Banks

HK\$ million		year-on-year change %	as a percentage of bank deposits
1973	21,578	29.8	82.4
1974	23,594	9.3	76.1
1975 Jun.	24,309	2.8	71.2
Dec.	24,998	6.0	68.8
1976 Jun.	26,975	11.0	68.0
Dec.	29,480	17.9	67.0
1977 Jun.	33,096	22.7	69.2
Dec.	36,856	25.0	69.5
1978 Jun.	42,640	28.8	70.6
Dec.	52,814	43.3	79.0
1979 May	60,640	46.1	84.2

Commercial Bank loans and advances have been growing at an accelerating pace since 1975.

A high demand for credit from the private sector need not matter if the supply of funds is restricted but as we have argued in past issues of AMM, there is no restriction on the supply side of the equation because the financial system can obtain all the reserves it needs (principally through the foreign exchange markets by bidding down the exchange rate).

On the other side of the coin, deposit rates may well have lagged inflation expectations, and they may well be below the 'market' which would explain the exodus of funds to the DTC's who offer 2 or 3 percentage points more on time and savings deposits.

In summary, it appears from the evidence available that the interest rate increases so far have not had a significant tightening effect. On the one hand the supply of loans has continued to grow to meet the demand for loans because the supply of reserves to the financial system remains uncurtailed. The demand for loans also continues to grow because heightened inflation expectations have largely discounted the record lending rates.

The bank deposit rates on the other hand have fallen below the market level causing a switch of funds to other financial institutions who can offer a better return. The credit expansion continues. All that has happened is that by manipulating interest rates the banks have given deposits to the finance companies.

Table 3

Ratios of Domestic Loans and Advances to Deposits

	<u>Banks</u>	<u>Deposit Taking Companies</u>	<u>Total</u>
1976 Dec.	67.0	-	-
1977 Dec.	69.5	-	-
1978 Dec.	79.0	97.1	81.4
1979 Jan.	80.6	84.7	81.5
Feb.	81.7	78.4	81.2
Mar.	82.8	74.0	81.3
Apr.	83.8	67.9	81.0
May	84.2	62.5	80.1

Net Lending by Deposit Taking Companies to the Banks

HK\$ millions

1978 Dec.	374	The Deposit Taking Companies have been increasing their lending to the commercial banks. DTC deposits have grown rapidly but their loans have not.
1979 Jan.	1,430	
Feb.	1,659	
Mar.	2,331	
Apr.	3,458	
May	3,845	

For lack of any more constructive occupation the authorities through the EBA may continue to fiddle with the corset strings. Further manipulation of interest rates will only give the non-bank financial institutions a competitive edge and it may cause a serious misallocation of resources. If the banks succeed in choking off loan demand temporarily by hoisting rates to new heights it will not be long before the highly competitive environment of Hong Kong breeds a new way of circumventing the controls. Hong Kong dollar bond issues may suddenly flourish, and non-bank institutions will join in using various new credit instruments. Loans and advances are not the only way of supplying funds to a would-be borrower.

Unless the supply of reserves to the financial system is controlled, aggressive interest rate hikes may prove only temporary in their effect on total credit expansion. The banks' self denial will rapidly be offset by the expansion of other financial sectors.

Conclusion: The published statistics for the period December 1978 to May 1979 indicate that the interest rate hikes have had no significant effect on total deposit growth or on total loans and advances.

The shift of deposits to the DTC's and the shift of loans to the banks indicates that the deposit interest rates of the banks were too low in that period, but that bank lending rates were quite competitive.

Further increases in bank interest rates are needed if the growth of bank credit is to be curtailed, but the growth of the total of monetary assets is more important and it is doubtful that hiking bank interest rates will achieve anything other than a very short-term effect on the total. The key to monetary restraint is the control of the supply of reserve assets - in Hong Kong this would be most easily achieved by restricting the supply of foreign exchange by controlling the exchange rate. Unless the government moves to a system of restraint based principally on controlling the supply of reserves either directly or through an exchange rate policy, the Hong Kong dollar will remain a weak currency and inflation may become a persistent problem.

JAPAN

A CHANGE IN THE PATTERN OF INFLATION

When a country pegs its exchange rate rigidly to a foreign currency, it simultaneously ties the behaviour of its overall domestic price level to the behaviour of the overall price level in that foreign country. When Japan pegged the yen to the dollar at the rate of ¥360 per US\$ between 1949 and 1971, it simultaneously locked the pattern of inflation in Japan to the pattern of inflation in the United States throughout that period.

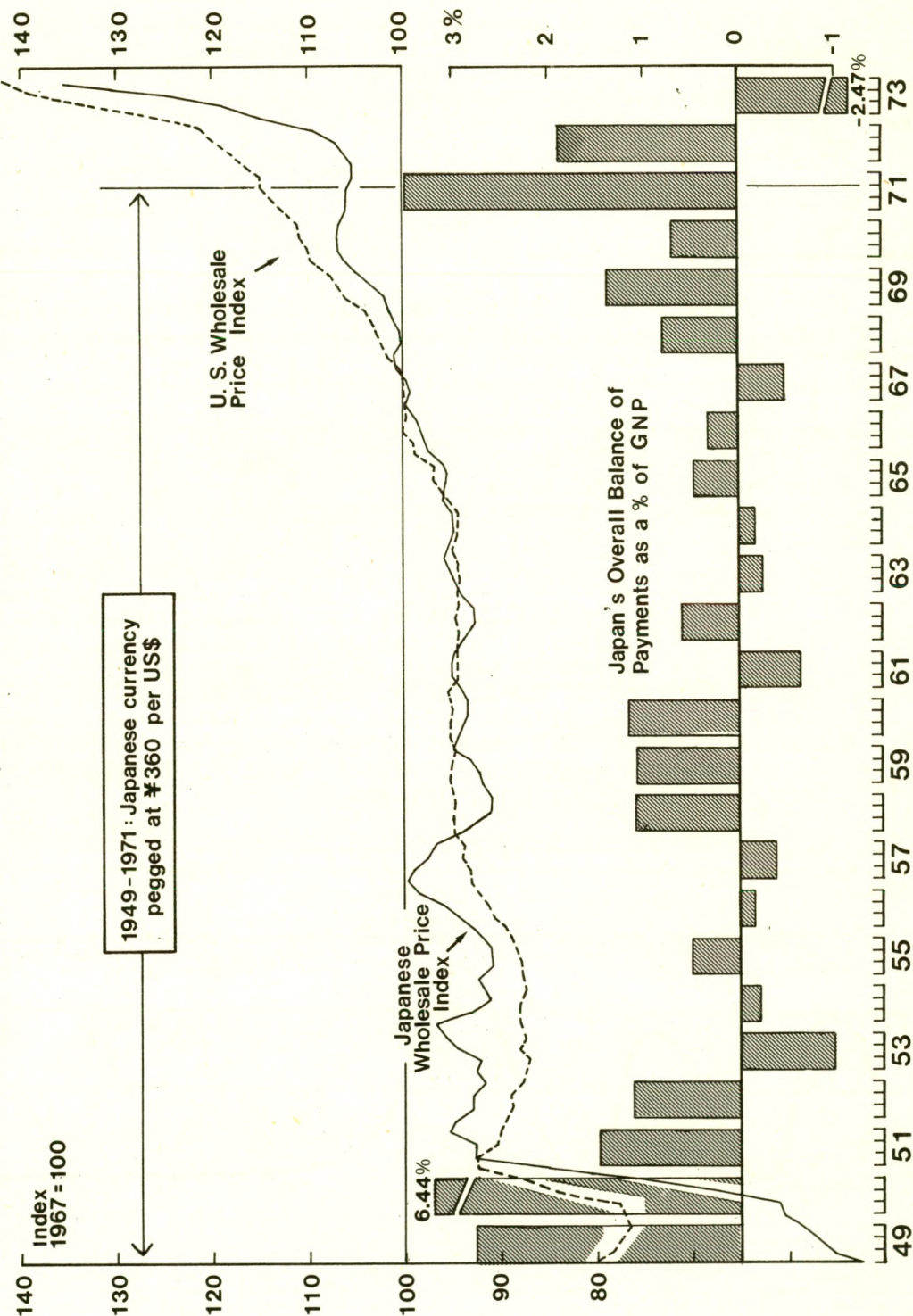
Broadly speaking, throughout the period 1949-71 wholesale prices in Japan fluctuated around wholesale prices in the United States, sometimes being a little above the level in America, sometimes being a little below the level in America, but never for very long. It was fortunate for Japan that US prices were, as Chart 1 shows, stable for most of this period, and only started to rise steadily and significantly in the late 1960s and early 1970s.

The mechanism involved in the process of keeping Japanese and American prices in line was a monetary one. If Japanese prices were "too high", Japanese exports would begin to slow down, Japanese imports would begin to accelerate and the balance of payments would switch from surplus to deficit. To make good the deficit and balance Japan's international payments at ¥360 per US\$ the Bank of Japan had to supply dollars by purchasing yen, and in so doing it reduced the reserves of the Japanese banking system, causing the money supply to decelerate. The deceleration of the Japanese money supply led to a slowdown in the Japanese economy, a shrinking of the demand for imports and a decline in the price level. Ultimately as exports became more competitive again, the balance of payments reverted to surplus. Then the converse process would operate, with a balance of payments surplus producing an expansionary monetary policy, and finally a general rise in prices. Thus the obligation of the Bank of Japan to intervene in the exchange market provided Japan with the classic automatic adjustment mechanism - a process by which monetary expansions and contractions brought Japan's price level into line with the price level in the United States.

To express the policy or the mechanism in a different way: all prices in Japan were forced to adjust to one price, the pegged exchange rate or the price of foreign currency in terms of Japanese currency. In terms of price indices this was reflected in a similar pattern of price changes in import prices, wholesale prices, and consumer prices. Chart 3 shows that in the period 1955-1971 the patterns of fluctuation of wholesale prices and import prices were extremely similar. At the next stage and with some lag, the fluctuation of consumer prices showed a similar profile, though the average rate of rise of consumer prices was higher. The average rate of change of the GNP deflator, the widest index of prices, was roughly

CHART 1

U.S. AND JAPANESE PRICE LEVELS, AND JAPAN'S BALANCE OF PAYMENTS 1949-73.



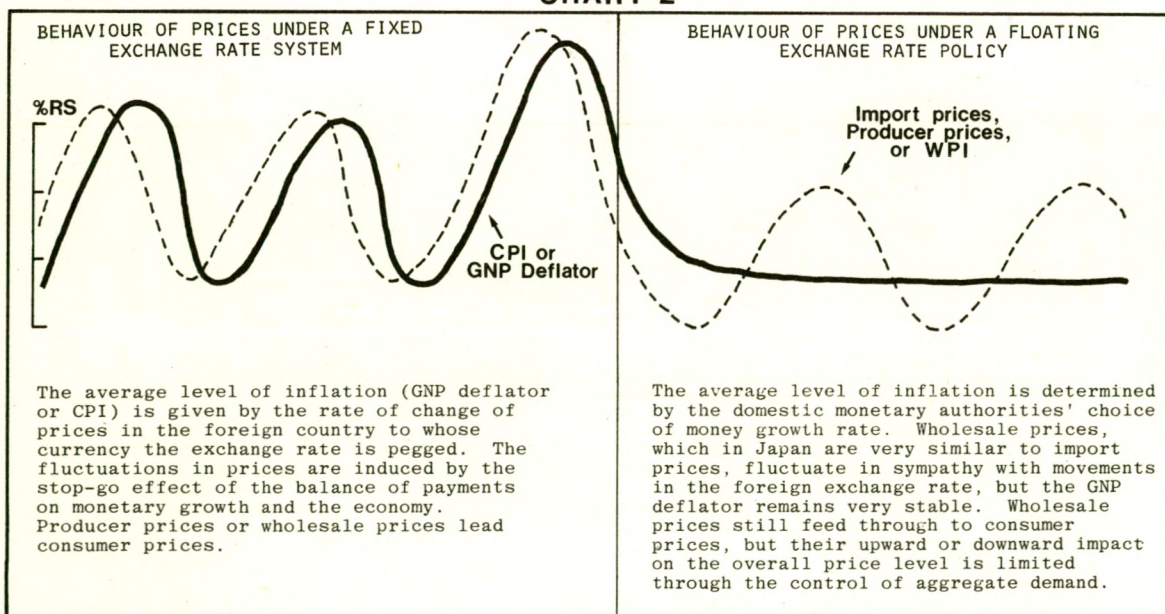
half way between that of consumer prices and wholesale prices, and again the pattern of fluctuation was similar.

Since 1971, however, the Japanese authorities have changed their policy. Their declared objective, first spelled out in 1974-75, has become the stabilisation of domestic prices. Although it is not entirely clear which price index the authorities have in mind, one may surmise that they aim to achieve a low average rate of increase of the GNP deflator or the CPI.

In order to achieve this objective the authorities have controlled the rate of growth of the broad money supply (M_2) and have allowed the exchange rate to vary in line with changes in the domestic and international demand for yen currency. In terms of the various price indices this suggests that movements of individual prices, especially import and export prices, and to a lesser extent wholesale prices, may fluctuate much more than they did prior to 1971, but the overall level of prices as measured by the CPI or GNP deflator will be much more steady.

Schematically one may picture all price indices fluctuating roughly together before 1971. After the change in Bank of Japan policy in 1974-75 and the freeing of the exchange rate, import prices and wholesale prices are likely to fluctuate around a stable trend of consumer prices. On average one may still expect wholesale prices to rise more slowly than consumer prices over periods of 2-3 years, but over shorter periods when the exchange rate is weak it may well be that wholesale prices will rise faster than consumer prices.

**JAPAN
CHART 2**



This theoretical pattern approximates surprisingly closely to the actual pattern of price changes shown in Chart 3. We may therefore conclude that the adjustment mechanism has altered. Previously it was an automatic process initiated by the central bank's obligation to intervene in the foreign exchange market. The automaticity resulted from the commitment to maintain a fixed exchange rate, but the consequence was that Japan - or any other country following this policy - could not choose its overall price level. The Japanese price level was determined by the level of prices in the U.S.A. Under these conditions it was reasonable to say that inflation was "imported".

Under the new mechanism all the adjustment occurs through changes in the exchange rate and there is no longer the accompanying monetary stimulus or restraining action which formerly caused overall prices to rise or fall. The adjustment process now occurs through a shift in the composition of any given overall price level, rather than through shifting the whole structure of price levels. Japan's import and export prices will therefore change, and the export and import sectors may expand or contract, but the overall GNP deflator which is the ultimate objective of policy need not change very much. Not only would the overall rate of price change remain unaffected, but Japan's overall level of economic activity would also be far less affected than it was under the old fixed exchange rate regime.

This change in the channels of transmission of price increases has probably been accompanied by some change in the relationship between monetary changes and the individual price indices. Whereas previously the relation between monetary expansions or contractions and wholesale price changes, for example, was quite clear and direct having a lag of only one or two quarters, wholesale prices may now become less closely related to the behaviour of the money supply but rather more closely related in the short term to the changes in the value of the yen on the foreign exchange market.

If the channels of transmission of the inflationary process have altered somewhat, what can one say about the overall rate of inflation at the consumer price or GNP deflator level?

Starting from a situation of stable aggregate nominal demand such as the Japanese authorities are apparently maintaining, we can trace through the process which occurs when the price of any one imported item (such as oil) rises. Consumers may either increase their expenditures on those imports and curtail their expenditures on other domestic items correspondingly, or they may reduce their expenditure on these imports and raise their expenditures on domestic goods. In the first case the price of the domestic goods must fall (or there will be some unemployment), and the overall inflation rate will be unchanged. In the second case less money is spent on imports and more money is spent on domestic goods: the composition of spending has altered but the overall level of spending is unchanged. Now if the exchange rate depreciates (for some reason unrelated

to monetary changes) causing an increase in the price of all imported goods, the argument is exactly the same. Of course if the central bank changes its monetary policy and hence undermines the assumption of stable aggregate demand, creating sufficient money to support a higher price level, that will produce a general inflation, but as long as the central bank sticks to its earlier policy, inflation will not be "imported".

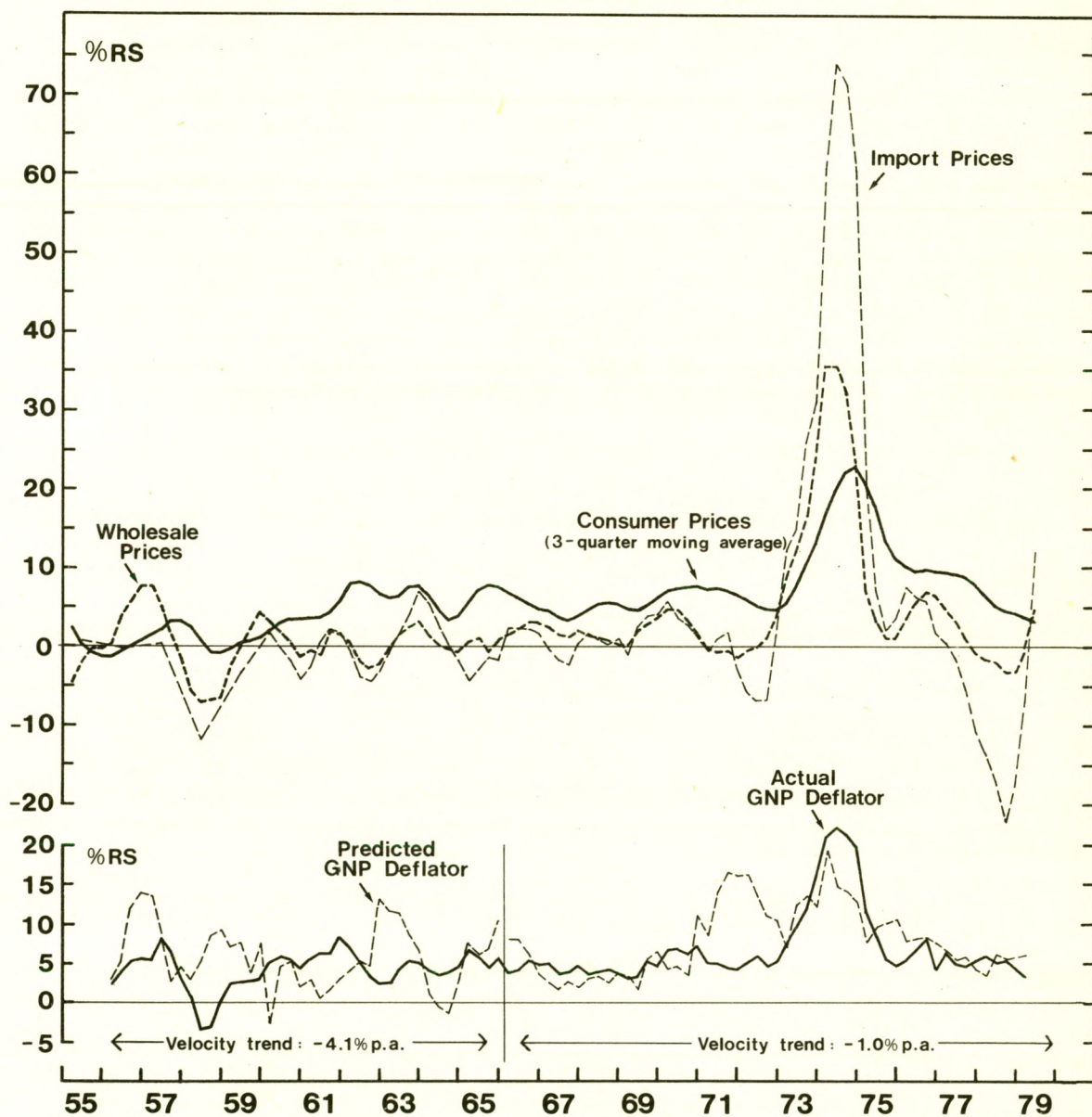
It follows that inflation is an entirely domestically-created phenomenon under present conditions in Japan. What then is the approximate underlying rate, and can the underlying rate be explained without reference to changes in the prices of imported goods?

The monetary theory of inflation depends on showing that the demand for money relative to total expenditures is fairly stable. In Japan the demand for money holdings was rising rapidly in the period 1955-65, and since then it appears to have risen much less rapidly. One piece of evidence suggesting that there has been a shift in the demand for money is the movement of the deposit-to-currency ratio. From 1949, when Japan started to conquer its immediate post-war hyperinflation, until 1965 or 1966 the deposit-to-currency ratio rose steadily from below 2:1 to around 11:1. Since 1966 this ratio has remained almost unchanged, suggesting that by then the Japanese had rebuilt their holdings of deposits relative to currency to some desired level, and since then the two components of the money supply have grown at almost the same rate. Since we know that cash currency holdings are largely held for transactions purposes, it must be presumed that deposit money holdings have also grown closely in line with other wider measures of transactions such as income. For the period 1956-65 we estimate that velocity (an inverse measure of the demand for money) was declining at 4.1% p.a., and for the period 1966-78 the trend rate shifted to a 1% p.a. decline.

Using these estimates, the actual rate of growth of M_2 and the real growth rate of the GNP it is possible to estimate the inflation rate for the implicit GNP deflator that Japan would have been expected to experience over these two periods, and compare that with the actual rate of change of the GNP deflator. For the period 1956-65 the estimates shown in the lower section of Chart 3 are quite close, and usually lead the actual rate of inflation. (This is due to the use of simultaneous measures of money and inflation, and different results could be obtained by using the GNP growth rate in a period one or two quarters later.)

In the period since 1966 the estimated inflation is quite close to the actual rate from 1966 through 1969, and then again in the period 1975-78. The intervening period shows a wider deviation between the estimated rate and the actual rate, largely due to changes in the lag between money and prices following the international financial turmoil in the wake of the "Nixon Shock" of August 1971, but the actual rate catches up with the estimated rate in late 1975 and 1976. Currently the predicted rate of inflation for the GNP deflator suggests

CHART 3 THE PATTERN OF INFLATION IN JAPAN



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7 per cent (year-to-year) is likely sometime during the remainder of 1979.

FORECAST: Wide swings in the yen-dollar exchange rate have altered the pattern of inflation in Japan. Since 1971 import prices and wholesale prices have varied quite widely in response to movements in the exchange rate, and may be expected to continue to do so. However, the recent upsurge in import prices and wholesale prices will not necessarily be translated into higher consumer price inflation. Our calculations based on the longer term relation between money, real growth and the demand for money suggest that the underlying inflation rate will rise to between 5% and 7%. Although wholesale and import prices can vary much more in the short term than consumer prices the longer term rate of inflation is fundamentally determined by the monetary growth rate, and shorter term swings in narrower price indices will not have a significant impact on the longer term rate.

PHILIPPINES

STAVING OFF DEVALUATION

Twice in the post-war period the Philippine peso has experienced a big devaluation: once in 1962 and again in 1970. Since the 1970 devaluation the currency has depreciated slightly, but in the past three years it has been held at around ₱7.30-7.40 per U.S. dollar. However the trade balance has been in deficit since 1973/74 (see Chart 1), inflation has started to rise again, and the level of external debt has doubled since 1975. How long can the authorities stave off another devaluation?

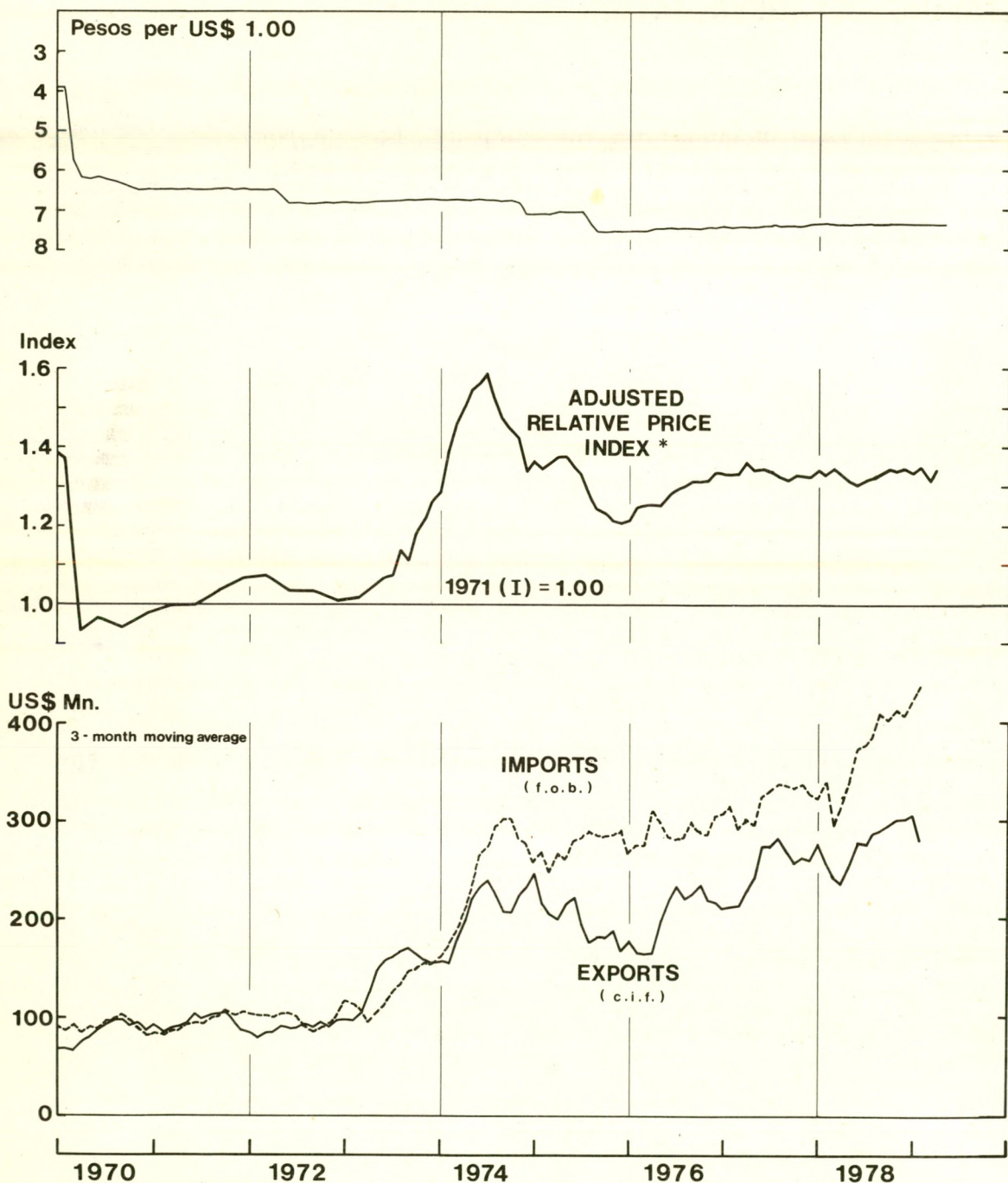
Background to the Devaluation of 1962

In the immediate post-war years from 1946 the Philippine peso was pegged at ₱2.00 to the US dollar under the terms of the Philippine Trade Act of 1946 drawn up by the U.S. Congress. The purpose of this, in the words of Rep. Wilbur D. Mills, was "to safeguard the value of capital that may go from the United States to the Philippines.....so that when capital decides to revert to the United States it may come to the United States without depreciation." Also known as the Bell Trade Act, its acceptance and passage through the Philippine Congress was required in order for the Philippines to be able to obtain U.S. funds under the Tydings or Philippine Rehabilitation Act. Many of the provisions of the Bell Trade Act were directed at restoring the pre-war trade preferences which the Philippines had enjoyed under its pre-war colonial status, but in addition U.S. citizens were given equal rights with Filipinos in the ownership and exploitation of natural resources. (This was the much-debated "parity" clause.)

The exchange rate provision of the Bell Trade Act was as follows: "The value of the Philippine currency in relation to the United States dollar shall not be changed, and no restrictions shall be imposed on the transfer of funds from the Philippines to the United States, except by agreement with the President of the United States."

For a few short years after independence (July 4, 1946) the Philippines benefitted from substantial dollar receipts derived from such sources as spending by American soldiers, US government disbursements for salaries of local employees, veterans' payments to Philippine soldiers, and reparation payments, all of which helped the currency to remain firm. As these inflows diminished, however, the country faced its first post-war foreign exchange crisis in 1949. Having obtained the consent of the US President that emergency measures were required to maintain the value of the peso, the Philippine government of President Quirino (1948-53) imposed extensive import and foreign exchange controls, subjecting almost all external transactions to Central Bank approval.

PHILIPPINES
CHART 1 : EXTERNAL TRADE, RELATIVE PRICES AND EXCHANGE RATE



* Philippine prices vs. U.S. prices adjusted for exchange rate changes.

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Between 1949 and 1962 the official exchange rate remained at ₱2.00 while the controls on trade and capital flows stimulated two sets of developments: (1) the growth of new local manufacturing industries protected from foreign competition and having preferential access to foreign exchange, and (2) a mushrooming of discontent associated with the corruption, favouritism and discrimination which inevitably accompanied the granting of licences, the fixing of quotas, and the wider administration of the controls.

In 1954-55 the Bell Trade Act was renegotiated and transformed into the Laurel-Langley Agreement, effective from 1956. (Senator Jose P. Laurel was head of the Philippine mission to Washington while Langley headed the U.S. delegation.) Philippine Central Bank Governor Cuaderno, a member of the mission, succeeded in eliminating direct U.S. control of the exchange value of the peso from the draft of the revised Agreement. The new position of the Magsaysay administration (1953-57) was therefore that as a member of the I.M.F. any major change in exchange rate policy would have to be passed upon by the Fund.

By 1958 the country was again facing a foreign exchange crisis, and this time Cuaderno attempted to negotiate a loan from the I.M.F., avoiding outright devaluation of the peso, but suggesting the imposition of a 25% tax on the sale of foreign exchange, which in effect would have resulted in a two-tier exchange rate. But the U.S. Government, acting through the State Department, had now switched its policy and preferred explicit devaluation and the removal of exchange controls. The US authorities therefore prevailed on the Managing Director of the IMF not to extend a stabilisation loan on Cuaderno's terms, and the Governor was obliged to go to private banks in New York to borrow the necessary short-term funds. Back at home the Central Bank's discount rate, which had been as low as 1.5% in 1956 and had been hoisted to 4.5% in 1957, was hiked further to 6% in 1959. In the nick of time the trade deficit narrowed, foreign exchange reserves recovered and the crisis was averted - for a while.

As a result of the 1961 presidential election, Carlos Garcia, President Magsaysay's successor, was ousted and replaced by Diosdado Macapagal in 1962. Whereas Garcia had alienated the traditional agricultural export interests - especially the powerful sugar farmers - by promoting somewhat nationalistic policies such as the nationalisation of the retail trade and had increased government subsidies for local manufacturers, Macapagal wooed the sugar merchants who desired closer political and economic ties with the United States, their major market. Macapagal's election victory was therefore followed by the lifting of import and exchange controls, and the adoption of a new tariff structure. The peso was allowed to float down to a new equilibrium, settling at around ₱3.90, a devaluation of 49%. Under the new arrangements exporters had to exchange 20% of their foreign earnings at the old ₱2.00 rate and the remaining 80% at the free market rate.

The effects of the 1962 devaluation were favourable.

Despite an apparent flood of imported consumer goods the trade balance shifted into surplus in 1963 and again in 1965, while foreign exchange reserves grew steadily year by year until 1966. Traditional agricultural and commodity exports revived. The graft and corruption born of the controls also diminished with their abolition. Against the background of the longest post-war business expansion in the USA which was just getting under way the outlook for the Philippine balance of payments in the late 1960's ought to have been good.

The devaluation of 1970

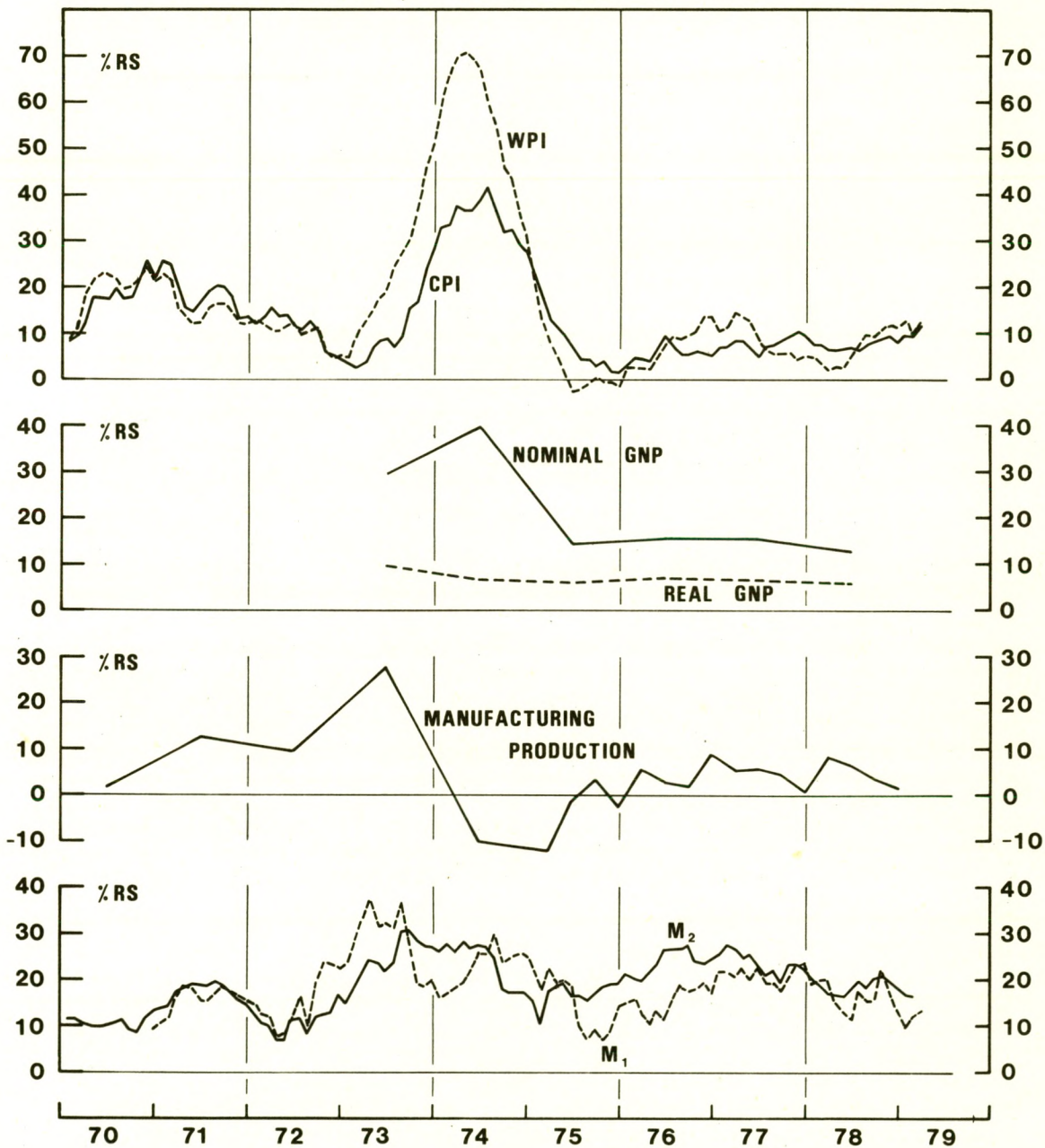
When Ferdinand Marcos defeated the incumbent Macapagal in the 1965 presidential election the external reserves position had been restored to the levels of the early 1950s before the 1957-58 crisis, and the trade balance was in surplus. But from 1967 onwards the international balance of payments once again deteriorated - notably in late 1969 as monetary conditions in the U.S. tightened and the American economy slowed, experiencing a mild recession from the third quarter of 1969.

In these early Marcos years foreign borrowings began to swell, escalating by the end of President Marcos' first term of office to \$1,880 million (compared with \$275 million at the time of the 1962 devaluation). In his campaign for re-election in 1969 Marcos pledged there would be no devaluation, announcing soon after his victory, "We have no intention of devaluing the peso because we would be hitting our low income groups, especially daily wage-earners and employees with monthly salaries." Bank loans and trade credit would be raised from America, Europe and Japan under World Bank sponsorship, Marcos declared, to finance the imports essential for development. But as pre-conditions for assistance the Bank and the IMF held out for devaluation and abolition of the new exchange controls which had crept back in as a means of alleviating pressure on the exchange rate.

Faced with a choice of repudiating the country's outstanding debt or devaluation, the government conceded to the IMF conditions and in February 1970 the peso again "floated" downwards, this time from ₱3.92 to around ₱6.40, or 39%. For its part the World Bank kept its side of the bargain, organising a consortium later in 1970 to raise over US\$300 million in new credits for the country in the next year. Such was the cumulative growth of foreign debt, however, that even this sum was not enough to cover debt amortisation and interest payments due in 1971. Nevertheless, following the February 1970 devaluation the recovery of the balance of payments from 1971 was more dramatic than after 1962, at least when judged by the level of foreign exchange reserves.

Helped by the world-wide commodity boom starting in late 1972, the country's foreign exchange reserves soared to new record levels. But because the subsequent growth of private and government foreign currency borrowing outstripped the rise in reserves, by 1975 when the world economy slumped, the decline in export earnings combined with a continuing high

CHART 2 PHILIPPINES MONEY, OUTPUT AND PRICES



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level of imports and larger debt servicing and amortisation requirements meant that the net foreign exchange assets of the monetary authorities fell sharply (Chart 3).

Common Ingredients of the 1962 and 1970 Devaluations

Because the 1970 devaluation followed a period during which there had been a substantial increase in foreign debt, it could be argued that the economic circumstances in 1962 and 1970 were quite different. Certainly the Philippines had less room for manoeuvre in 1970 as compared with the situation in the late 1950s when a domestic squeeze combined with a small foreign loan had enabled the authorities to postpone devaluation. However, examination of the accounts of the monetary authorities shows that a critical trigger for both devaluations was set off by the level of net official foreign assets.

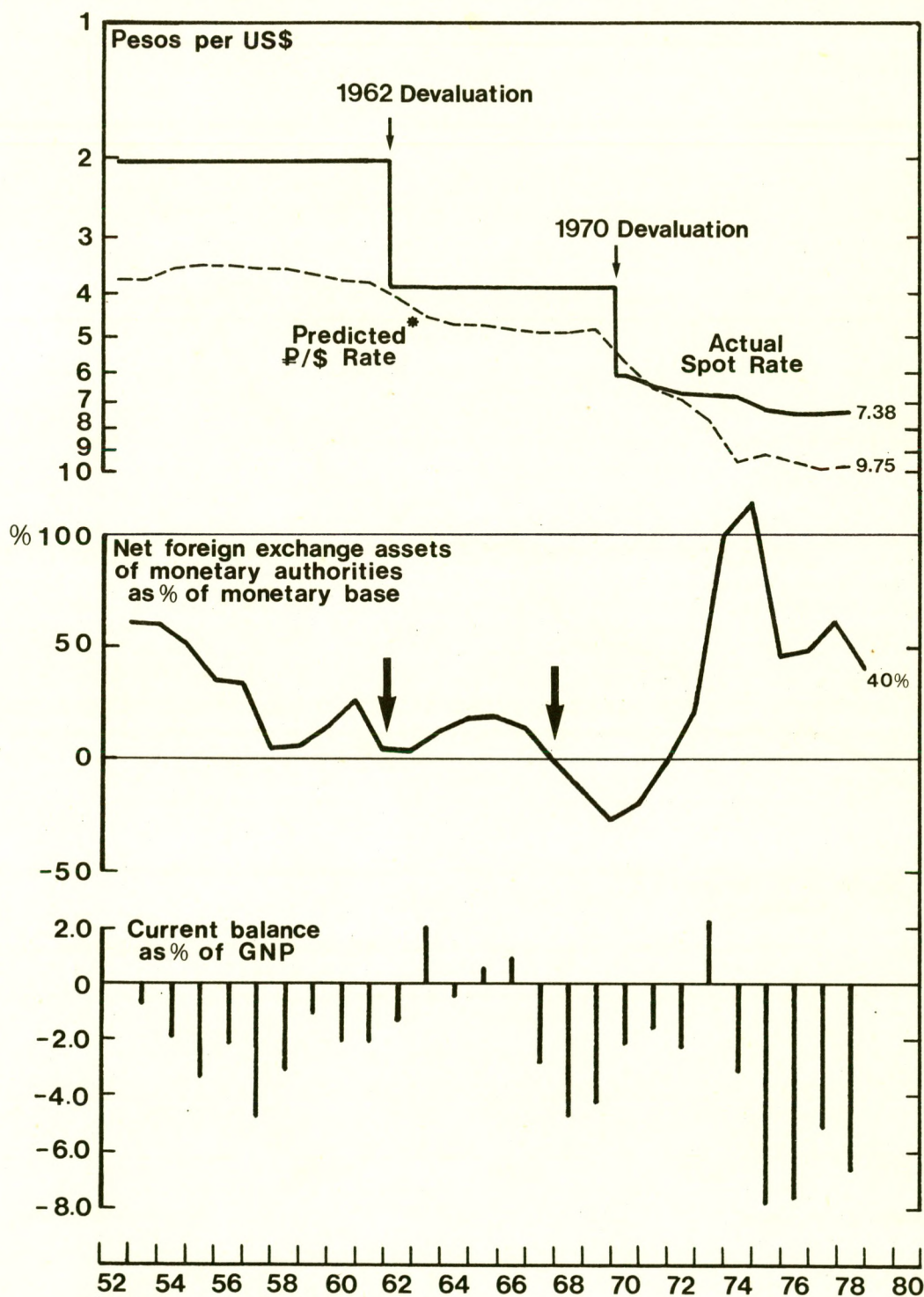
If gross official foreign exchange assets on their own are considered, it would appear that the present situation in the Philippines is far stronger than either 1962 or 1970. However, since it must be remembered that all earnings on these assets must first be utilised to repay interest and principal falling due on a substantially larger burden of official or government foreign liabilities, only the residue after these payments will be available to finance any balance of payments shortfall of the private sector. Therefore the closer the net official foreign assets position approaches to zero, the less room the authorities have to manoeuvre in the event of a deterioration in the balance of private sector receipts and payments.

In order to adjust for the growing scale of the economy over the years the net foreign assets of the monetary authorities are shown in Chart 3 as a percentage of the monetary base. The steady decline of this percentage in the mid-1950s shows up clearly, as does the brief recovery following Governor Cuaderno's squeeze of 1958-59. When net foreign assets again dropped to zero at the end of 1961 (indicated by the large arrow on the left in Chart 3), the writing was on the wall for the peso. In the first quarter of 1962 the currency was devalued by 49%.

The rise in net foreign assets of the authorities after the 1962 devaluation was modest, and, as the burden of official foreign debt began to mount, the upward trend was reversed after 1966. When net foreign assets fell below zero as early as December 1968 (shown by the large arrow on the right in Chart 3), devaluation was virtually unavoidable. Even a steep hike in the discount rate to 10% in 1969, unlike the 1959 episode, could not stave off devaluation. So once again the exchange value of the peso was cut, this time in February 1970 by 37%.

The world-wide commodity boom of 1973-74 and the huge increase in the Philippine's foreign currency earnings, gave the authorities exactly the opportunity they needed to build up their reserves again. Also, far from allowing the peso to strengthen and so dampen the inflationary consequences of the build-up of foreign reserves, the authorities held the peso

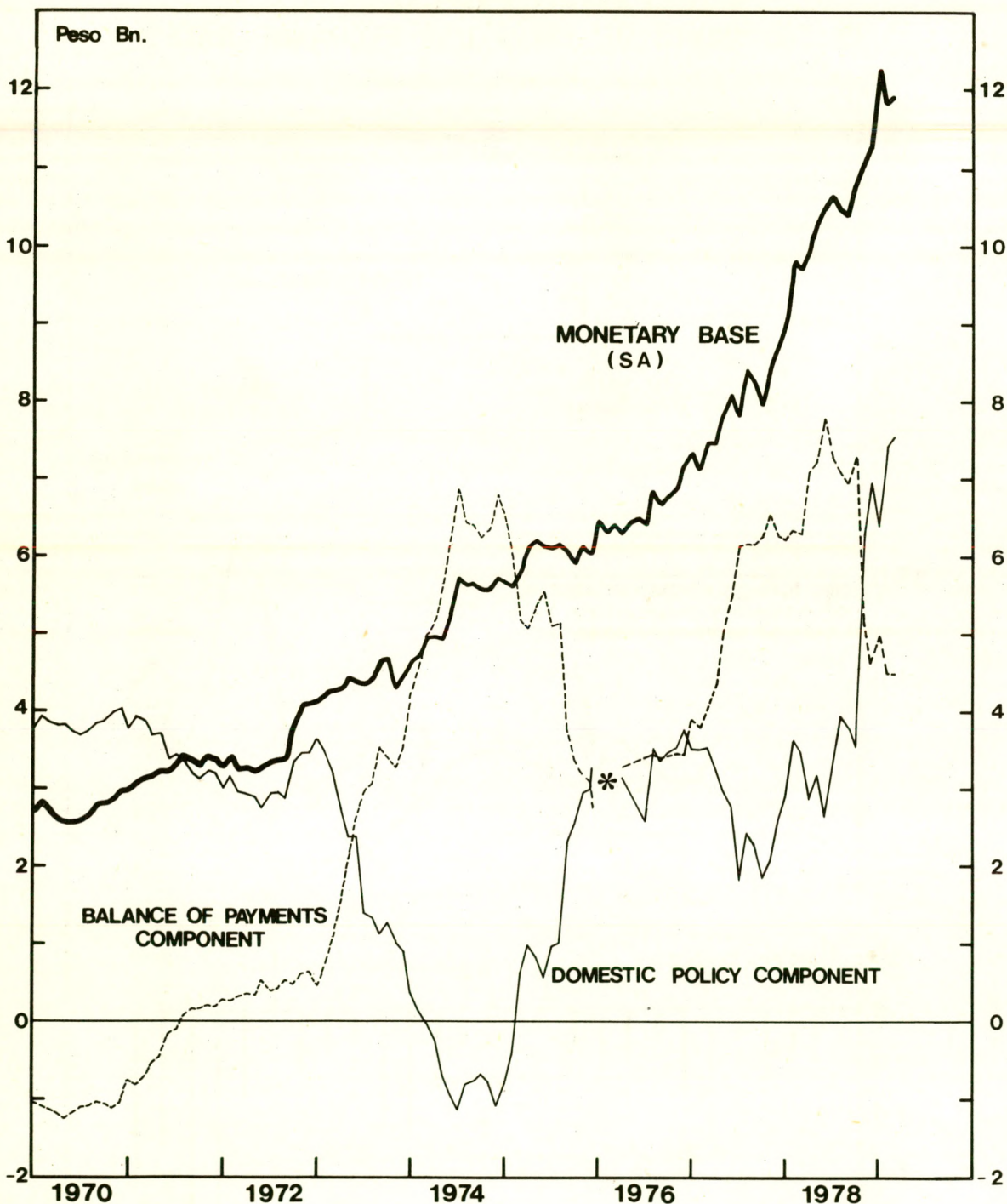
CHART 3 PHILIPPINES DETERMINANTS OF THE P/US\$ EXCHANGE RATE



* Based on US and Philippines WPIs;
1971 assumed to be equilibrium year.

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PHILIPPINES CHART 4 : MONETARY BASE AND COMPONENTS



down (Chart 1), and thus enabled their net foreign assets to grow to a point where they actually exceeded the size of the monetary base. Unfortunately the slump from late 1974 through 1975 caused a pronounced downturn in exports while imports remained at much higher levels, so that the balance of payments shifted to deficit. To maintain the value of the peso the authorities had to draw on their net reserves, with the result that the balance of payments component of the monetary base slipped back until it accounted for less than 50% of the total.

In 1976 and 1977 there was some recovery in the net foreign asset position, but by the end of 1978 the situation was deteriorating quite rapidly. This is also shown by the fall in the balance of payments component of the monetary base in Chart 4. To plug the haemorrhage, the authorities are now imposing another financial squeeze, just as they did in 1958-59. This time Central Bank Governor Licaros has closed the CB's repurchase window, effectively reducing CB credits to the commercial banks, and causing the money supply to slow down. Will the current squeeze be successful in halting the decline in net foreign assets?

One measure of how much the Central Bank has to achieve is given by the relative level of prices in the Philippines compared with prices in the USA. Chart 1 shows that, starting from a base after the 1970 devaluation and adjusting for subsequent exchange rate changes between the peso and the US dollar, prices in the Philippines have risen substantially more than price levels in the USA. To bring prices in the Philippines back into line with American prices as they were in 1970-71 after the last devaluation there will have to be some combination of three changes:

either U.S. inflation must continue at a more rapid rate than in the Philippines

or Philippines price rises must be slowed dramatically - even causing an absolute decline in prices

or finally, the Peso/Dollar exchange rate must be changed.

Assuming that 1971 was an "equilibrium" year and that the composition of the wholesale price indices in the US and in the Philippines are reasonably representative of the goods produced and traded internationally by each economy, one can calculate the Peso/US\$ exchange rate which would be necessary to restore price levels in the two countries to the same relative levels as prevailed in 1971. This calculation yields the predicted exchange rate shown by the dashed line in Chart 3, and suggests an exchange rate of ₱9.75 compared with the current rate of around ₱7.40.

FORECAST: Despite its large trade deficit, the recent acceleration of inflation, and the increased burden of foreign debt, the Philippines currently enjoys a greater margin of manoeuvrability than it did ahead of the devaluations of 1962 and 1970. This is because the net foreign asset position, equivalent to 37% of the monetary base, is still reasonably sound. Provided that the Central Bank persists with its squeeze, bringing down monetary growth sufficiently to choke off some of the demand for imports, the Philippines could avoid devaluation. If however the authorities are not firm in their resolve and permit monetary growth to continue at the rates experienced in 1977 and in the latter half of 1978, then our purchasing power parity exercise suggests that the peso will need to be devalued by approximately 25% to restore equilibrium in the international balance of payments.



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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

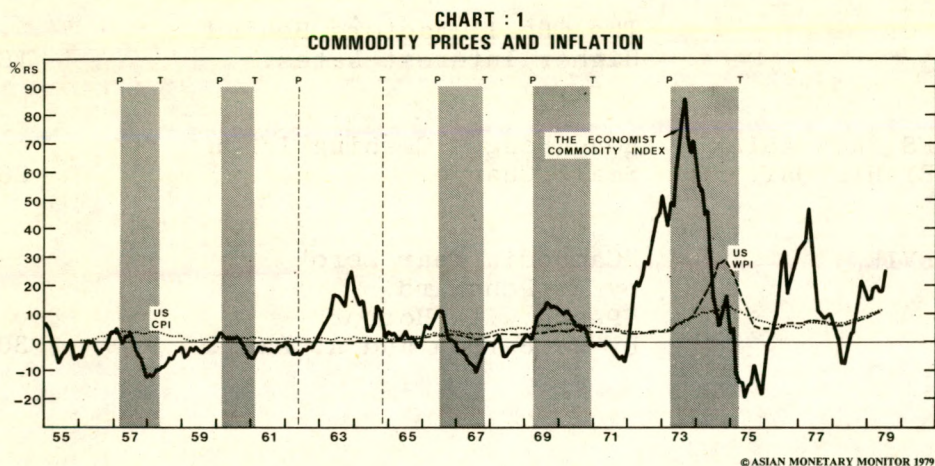
SAAR - Seasonally Adjusted at Annualised Rate.

REGIONAL SURVEY

COMMODITY CYCLES AND REAL COMMODITY PRICES

As more and more signs of a US recession emerge the countries of the Asian region must consider the implications for their major commodity exports. Places like Australia and Malaysia have enjoyed a substantial fillip to their trade balances from the buoyant commodity prices and the Philippine stockmarket had firm copper prices to provide cheer in an otherwise very unfavourable economic climate earlier this year. Any tendency for commodity prices to fall must therefore be of considerable concern to investors in the region.

On a macroeconomic level past experience suggests that a period of declining commodity prices is most likely during a slowdown in the US economy. Chart 1 shows the rate of increase in the Economist Commodity Price Index over the past 24 years against the peaks and troughs in the US 'growth' cycles over the same period. (Growth cycles include slowdowns in the rate of growth as well as periods of actually declining output.)



Falling commodity prices were associated with five of the past six downturns in US economic activity. The exception, the 1962-64 downturn during which commodity prices were firm, was by far the mildest of the cycles in the period and it is arguable whether it should even be classified as a cyclical downturn. (Hence its designation with dashed lines in Chart 1.)

It is clear from the chart and also from Table 1 that commodity price cycles have become more volatile since 1970, doubtless reflecting the greater instability and sharp changes in monetary policy which are associated with high inflation rates throughout the world. Thus the argument that the cyclical downturns in commodity prices will be 'cushioned' by a generally higher inflation rate bears little credence; cyclical factors have overwhelmed longer-term inflationary considerations in each of the last three downturns. There were absolute declines in overall commodity prices of the order of 14%, 11% and 21% in the 1967, 1970 and 1975 episodes respectively despite the

progressively higher underlying inflation rates in the US in these periods.

The effect of inflation on commodities has therefore been primarily seen in the upswings when commodity prices have risen at rates at least double the US consumer and wholesale price inflation rates, and the downswings have in contrast continued to show sharp nominal declines. Inflation is therefore very unlikely to 'hold up' commodity prices in the next downturn.

TABLE 1

COMMODITY PRICE CYCLES: PERCENTAGE CHANGES IN THE 'ECONOMIST' INDEX

UPTURNS			DOWNTURNS		
TROUGH →	PEAK	(%)	PEAK →	TROUGH	(%)
(1)		-	Feb.57-Apr.58		-18.1
(2)	Apr.58-Feb.60	+ 5.0	Feb.60-Feb.61		- 6.7
(3)	Feb.61-Jun.66	+36.4	Jun.66-Oct.67		-13.5
(4)	Oct.67-Mar.69	+19.1	Mar.69-Nov.70		-11.1
(5)	Nov.70-Mar.73	+190.4	Mar.73-Mar.75		-20.8

N.B. Dates given refer to major U.S. business growth cycles; commodity price changes refer to associated movements (i.e. not necessarily the same dates) of the Economist Commodity Price Index (month average data).

In the three U.S. business cycles (1)-(3), the peaks and troughs of the Economist Commodity Price Index closely coincided with peaks and troughs in the business growth cycle. In the last two upturns, however, the lag between the business peak and the commodity price peak was just over one year, and the lag during the 1969-70 downturn was also one year.

So far we have considered only the relationship between economic activity in the United States and commodity prices. In the fifties and sixties when the US economy dominated world demand for commodities such an approach was justified. Moreover, in those decades the industrialized countries followed business cycles in step with each other, linked by the Bretton Woods fixed exchange rate regime, so that the whole world approximately followed the US business cycle.

Since 1970 frequent exchange rate adjustments and floating exchange rates have become the order of the day and the linkage binding other countries to the US economy has been broken, and there is no longer a necessary reason for the rest of the world to follow the US into recession. In terms of size US dominance of world economic activity has also diminished in recent years. For both these reasons commodity prices are less likely to follow the US business cycle as closely as in the past.

There has already been one demonstration of the looser relationship between the US economy and commodity prices. From

April to October 1977 the commodity price index fell 18%; the drop was the largest and sharpest fall in commodity prices in the past thirty years which was not associated with any slowdown in the US economy. In other words that fall could not have been predicted by looking at the US economy alone. The reason was that more or less simultaneously in Britain, Japan Germany and France there were downturns in business activity. Collectively these economies now have an aggregate GNP greater than the GNP of the USA, and an economic pause in these countries was more than enough to counter the strengthening demand in the US and cause commodity prices to stabilize and even decline.

In 1979 the situation is just the opposite. So far as we can judge the United States is entering a recession but most other major nations appear to be enjoying buoyant activity. Assuming for the moment that there is no slowdown in the other economies, the overall effect on the commodity prices of a recession in the US will probably be similar to the experience of 1977 i.e. there will be a fall in the index and it will probably be by at least ten percent. If in addition other countries experience a slowdown the downside for commodity prices is correspondingly greater. Either way, it is difficult to see commodity prices in general either continuing to rise or even holding level in the next twelve months.

Turning to individual commodities, the general pattern is overlaid by many special factors relating to particular market conditions, but we will concentrate on only one question here: have commodity prices kept pace with inflation over the past decade? Put another way; are commodity prices relatively cheap or expensive in real terms?

CHART : 2
COMMODITY PRICES ADJUSTED FOR INFLATION

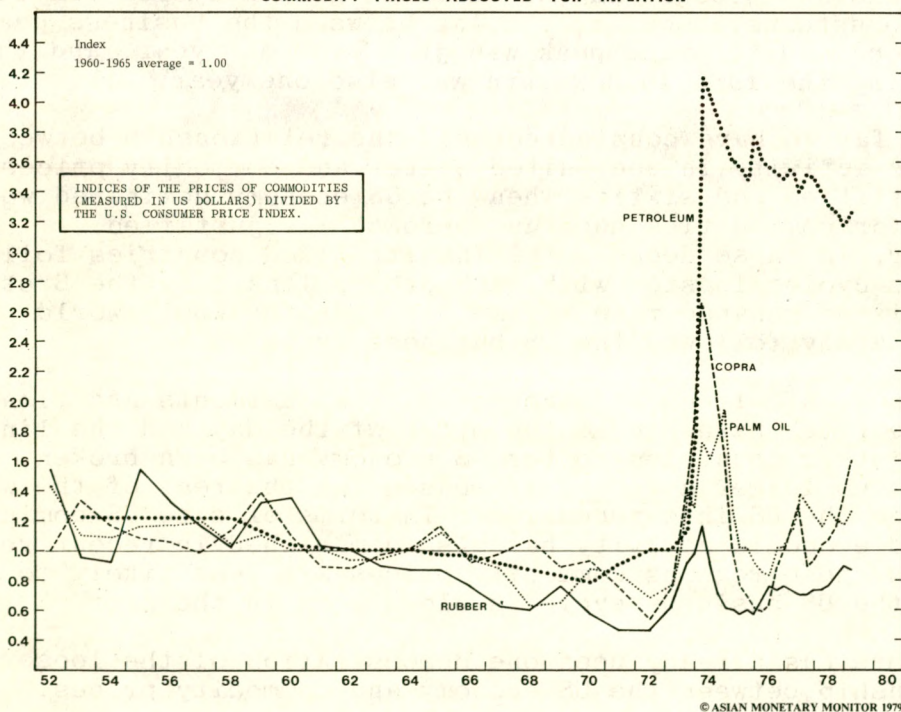
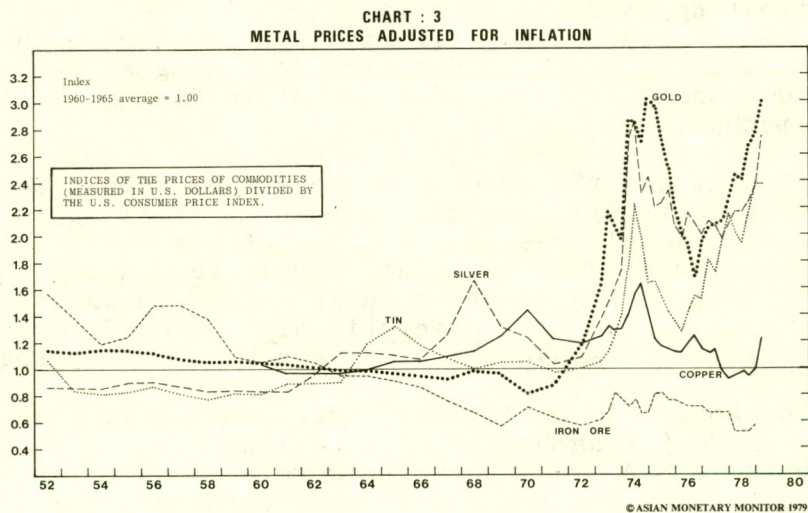


Chart 2 shows the prices of some major export commodities of Malaysia deflated by the US consumer price index. Throughout the sixties these commodity prices declined in real terms and rubber, Malaysia's main export, fell as much as 58% in real terms during the decade. From 1972 onwards the declining trend appears to have been arrested and prices in early 1979 all appeared to be comfortably at or above the real long term downward trend.



A similar story is told by the metals in Chart 3, though of those shown, iron ore is the only one ever to have displayed a steady declining trend in real terms. Iron ore and copper have both been rather sad performers in the long run although copper has now recovered to its real price level in the early seventies. Neither can compare with the dramatic appreciation in the real value of gold and silver since 1972 which can no doubt be ascribed to these metals' traditional role as stores of value in inflationary times. Both have now returned to their 'peak' real values attained in the inflation of 1974.

The Economist Commodity price index itself has outpaced inflation handsomely since the 1975 trough, and now (August 1979) it has a real value equivalent to that at the very peak of the cycles in 1974 and 1977 (which are incidentally the highest 'real' peaks since the end of the Second World War). Against such a background it is very unlikely that commodity prices will continue to rise and some substantial falls are a serious possibility.

A DISCRETIONARY ADJUSTMENT MECHANISM

It is widely agreed that the way in which Hong Kong's economy 'adjusts' to the rest of the world has changed in recent years. The clearest expression of this change was the move to a floating exchange rate in November 1974. However since that time, both public officials and private businessmen and bankers have continued to describe Hong Kong's adaptation to the world economy in terms of a so-called "automatic adjustment mechanism".

Exactly what was the automatic adjustment mechanism, and to what extent is it still operating? Is it still appropriate to describe Hong Kong's response to the outside world in these terms? In particular does the money supply (and hence the price level) in Hong Kong respond in an automatic way to external developments, or is it now a discretionary matter determined by the authorities, the banks and the non-bank public together?

When the Hong Kong dollar was pegged to sterling and the US\$, prices in Hong Kong had to move in line with prices in Britain and the U.S.A. Of course this relationship was not an exact one, but to see how stable and dependable this relationship was it is worthwhile examining the behaviour of relative price levels in Hong Kong and its major trading partners during the 1950s, 1960s and early 1970s.

The Charts 1 and 2 show the actual price level in Hong Kong over a 22 year period from 1952 to 1974 using linked annual averages of the various consumer price indices compiled in Hong Kong.* The upper chart shows the price level in Hong Kong predicted by the movement of price indices in each of the economies of her major trading partners. The predicted price levels are calculated from the C.P.I. in each country, and adjusted for revaluations or devaluations of the currency in question vis-a-vis the HK\$.

It is clear from the upper chart (Chart 1) that prices in the U.S.A. have been the dominant influence on the price level in Hong Kong. Since the U.S. has also been Hong Kong's largest trading partner from 1960, this suggests that the relative influence of foreign countries' prices on the Hong Kong price level depended on the extent of transactions between the two countries. Therefore in the lower chart a composite predicted price index has been constructed using as weights the relative shares of each of the four major countries in Hong Kong's trade. The close correspondence of Hong Kong's actual overall price level and the price level predicted from prices overseas clearly illustrates the effectiveness of the automatic adjustment mechanism through this period: prices in Hong Kong were kept firmly in line with prices overseas.

*1947-67 Retail Price Index: All Items (March 1947 = 100).

1965-75 General and Modified Consumer Price Index (1963-64 = 100).

1974-78 Average of New Consumer Price Index 'A' and 'B', and Hang Seng Consumer Price Index (1973-74 = 100).

CHART 1: HONG KONG
ACTUAL CONSUMER PRICES AND PREDICTED PRICES

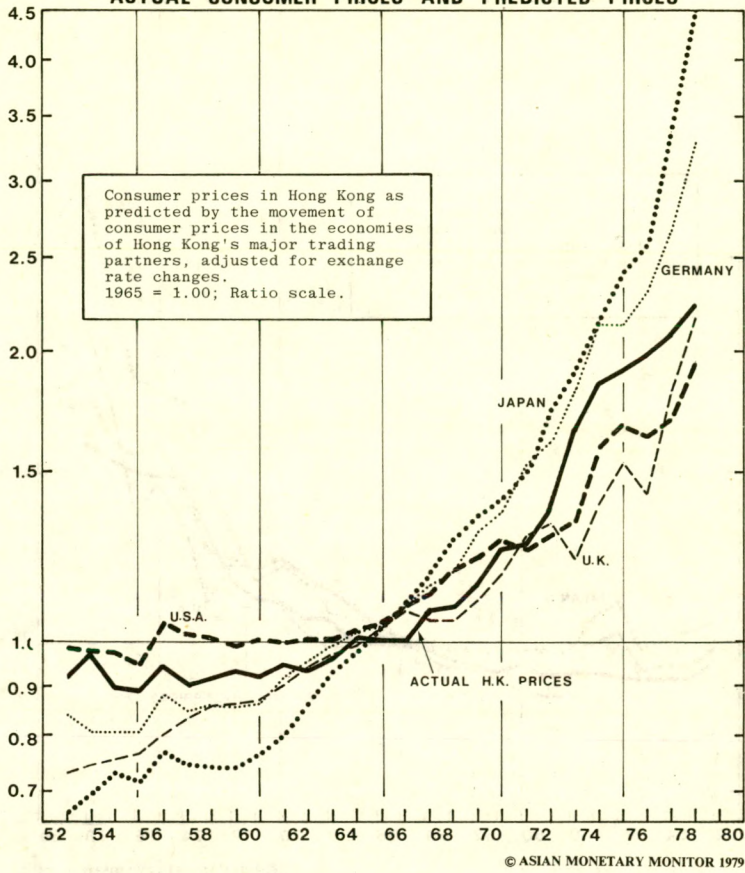
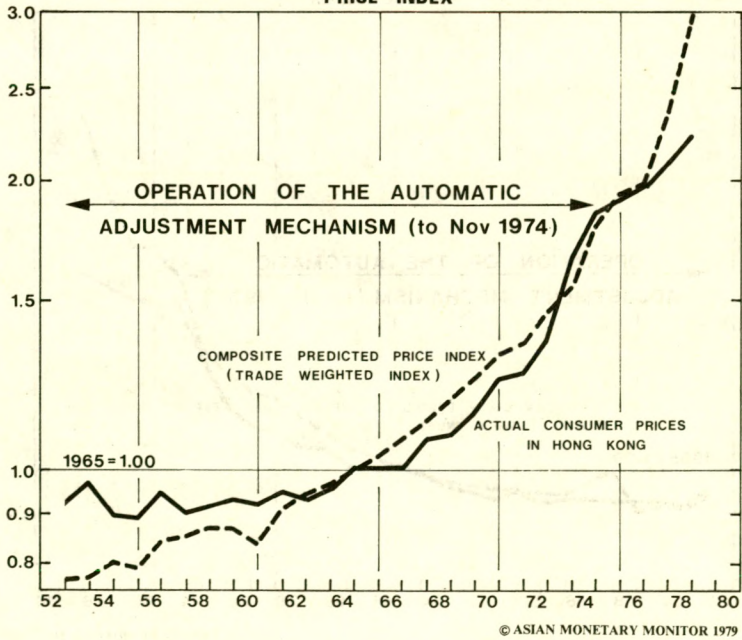
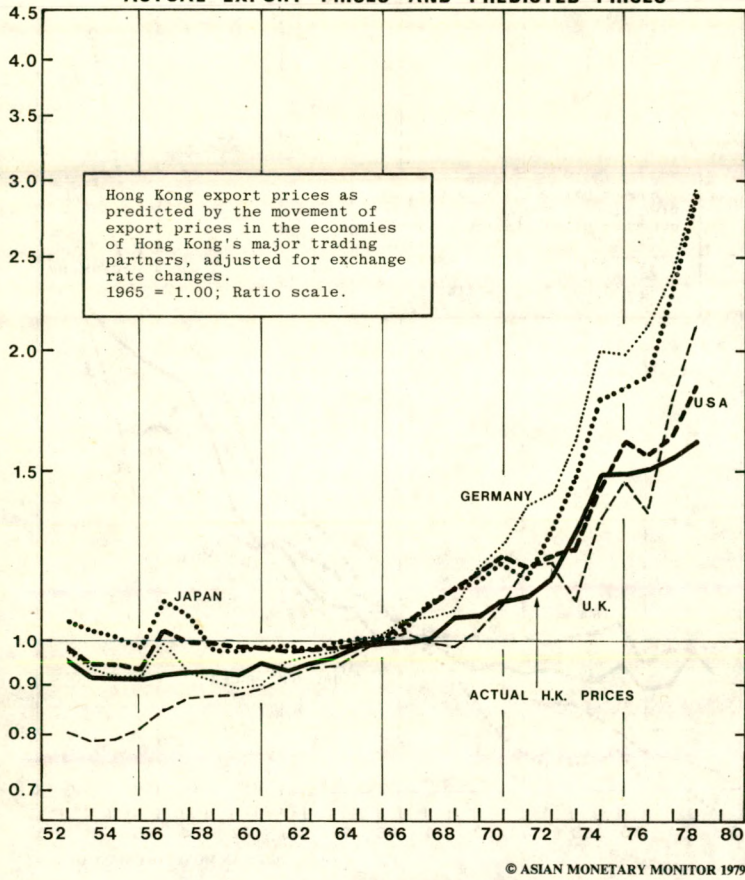


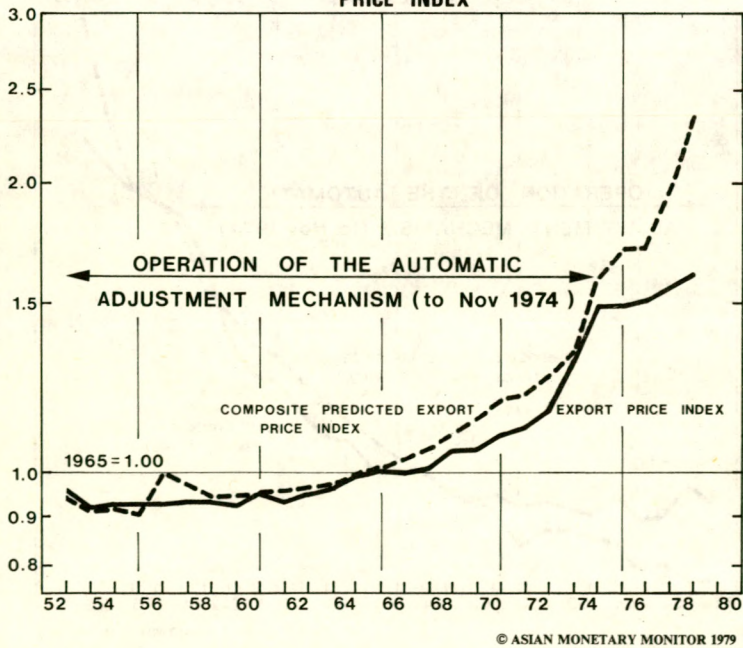
CHART 2: HONG KONG
ACTUAL CONSUMER PRICES AND COMPOSITE PREDICTED PRICE INDEX



**CHART 3: HONG KONG
ACTUAL EXPORT PRICES AND PREDICTED PRICES**



**CHART 4: HONG KONG
ACTUAL EXPORT PRICES AND COMPOSITE PREDICTED
PRICE INDEX**



Charts 3 and 4 show the results over the same period using price indices for Hong Kong's export goods. The export price index used here is not the official unit price index but is compiled from Hong Kong's consumer price indices in such a way as to exclude the purely domestic components of the price indices (e.g. rents) and to reflect the composition of Hong Kong's exports. Evidence from other countries suggests that price indices of internationally traded goods give better results in purchasing power parity exercises of this kind than other domestically-oriented indices. As one might expect the predicted composite index comes closer to the actual series than is the case with the consumer price tests in Charts 1 and 2. These results again provide confirmation of the success of the automatic adjustment mechanism in keeping Hong Kong's prices in line with prices overseas during the period when the exchange rate was rigidly pegged.

The adjustment mechanism, or the mechanism that kept Hong Kong's prices in line with prices elsewhere, was a monetary one. If Hong Kong's prices were low relative to prices elsewhere at the prevailing fixed exchange rate, this generated a balance of payments surplus which in turn resulted in the banks accumulating net foreign currency assets. Under the existing Currency Board system, banks could then expand their loans (or overdrafts) in Hong Kong currency. The increased lending would be matched by a higher level of deposits in the system, and increased expenditure throughout the economy leading in time to more imports, and a higher overall level of prices. At the next stage this would produce a reversal in the balance of payments position, whereupon the whole mechanism would start to operate in reverse. A decline in the net foreign currency assets of the banks would induce a cutback in lending growth and deposit growth, a deceleration or decline in overall expenditure, and ultimately a strengthening of the balance of payments again.

To summarise: Given the fixed exchange rate and the obligation of the Exchange Fund to buy or sell Hong Kong currency for foreign currency at that fixed rate, the money supply automatically adjusted to whatever level was necessary to keep the balance of payments in equilibrium. In this way overall price levels (adjusted for exchange rate changes) in Hong Kong and its trading partners remained closely in line with each other.

THE MONETARY IMPLICATIONS OF A FLOATING EXCHANGE RATE

Once Hong Kong moved to a floating exchange rate (from November 1974), this strong binding link between price levels in Hong Kong and price levels elsewhere was broken. It was no longer necessary for prices in Hong Kong to march in step with the prices of its major trading partners. Upward movements in prices overseas could be offset by an appreciation of the HK\$ exchange rate, and conversely, upward movements in Hong Kong's prices could be brought into line with prices overseas by a depreciation of the Hong Kong currency. (For a diagrammatic analysis of the breakdown of the automatic adjustment mechanism see pp. 14-15.)

Given that price levels overseas are determined by the domestic monetary growth rates resulting from policies pursued in the various different countries, and assuming that the Hong Kong dollar is allowed to float freely, the problem is what now determines the quantity of money in Hong Kong and its growth rate?

As we have argued in past issues of AMM, Hong Kong's money supply is not subject to any satisfactory mechanism of control. In the first place the banks have unrestricted access to reserve assets, there being no monetary authority to restrict the supply of such assets, and the definition of Specified Liquid Assets being unsatisfactory in any case from the standpoint of monetary control. Second, the manipulation of interest rates in an attempt to restrict lending by one group of financial institutions - the licensed banks - has only diverted credit-creating activity to another group - the finance companies.

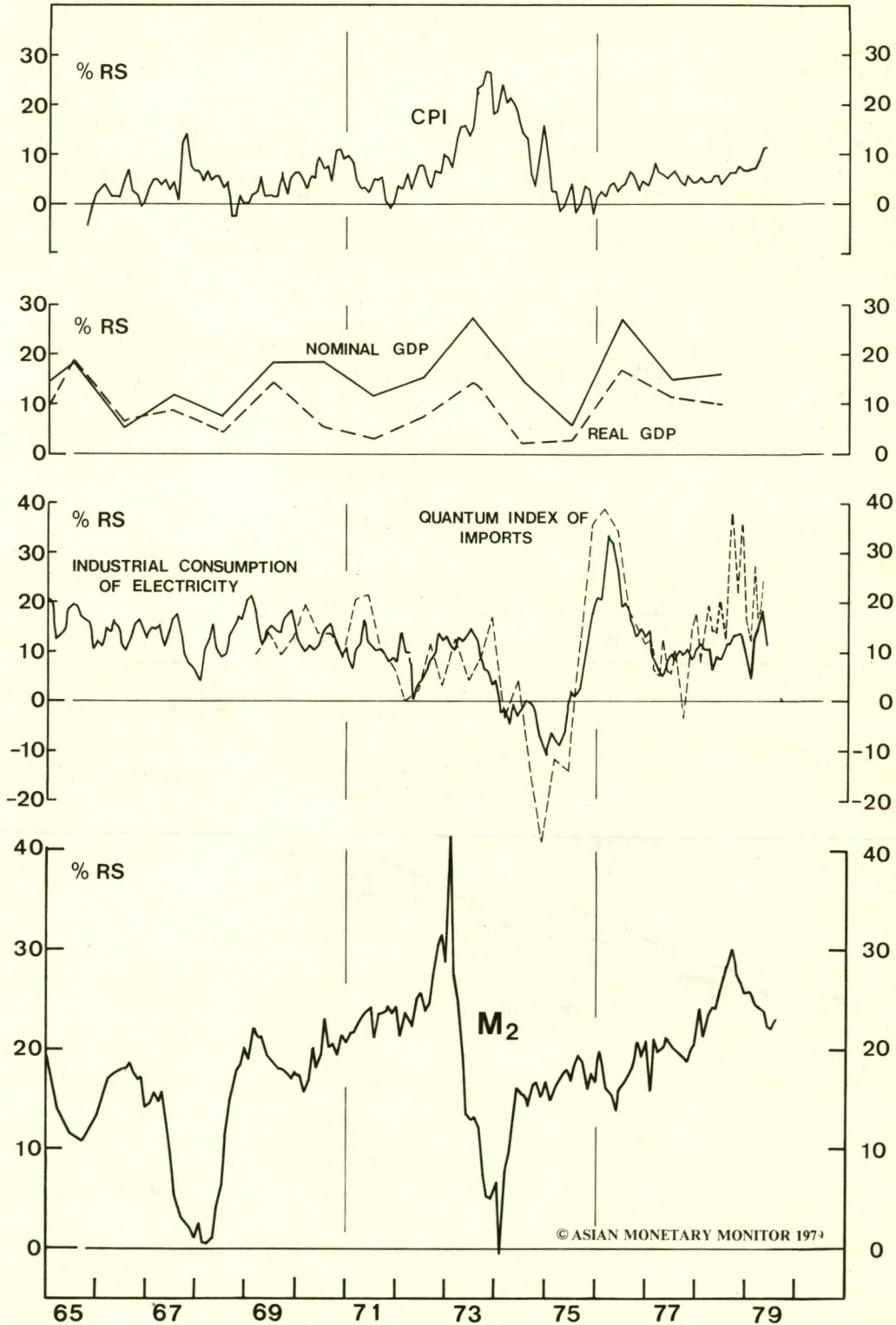
Consequently monetary growth in Hong Kong has ballooned over the past four years, and prices are now beginning to rise quite steeply in response to the long period of excess money growth. In Charts 1-4 this is foreshadowed by the wide deviation which has opened up between the actual level of prices in Hong Kong and the predicted price level. Suddenly in 1978 the gap became much wider than in the past, suggesting either that Hong Kong prices were likely to rise substantially further in 1979, or that the depreciation of the Hong Kong dollar against the yen and DM in 1978 was overdone and that there was due to be some correction in 1979, or that some combination of these two must occur. Due allowance must of course be made for the wide differences between the price indices being used and the rather crude nature of this cross-country comparison of price indices. Nevertheless, although the data is certainly open to questioning, the issue of principle appears to be well illustrated by our findings.

During the period 1952-64 price levels in Hong Kong's leading trading partners were very stable. Thanks to the fixed exchange rate, prices in Hong Kong were also extremely stable, rising at only 0.8% per annum.

Between 1964 and 1974, prices overseas rose more or less continuously, and, again as a result of the pegged Hong Kong dollar exchange rate, prices in Hong Kong also rose more rapidly. Tied to the rising price levels elsewhere through the automatic adjustment mechanism, consumer prices in Hong Kong rose at an average rate of 6.3% per annum over this 10 year period.

In 1973-74 the combination of a domestic boom in Hong Kong and the fixed exchange rate must have produced a large balance of payments deficit. The automatic adjustment mechanism effectively translated this deficit into a monetary contraction (see Chart 5), and as a result the inflation rate in Hong Kong in 1974 and 1975 dropped sharply from over 20% per annum in early 1974 to roughly zero in 1975.

HONG KONG
CHART 5 : MONEY, OUTPUT INDICATORS, AND PRICES

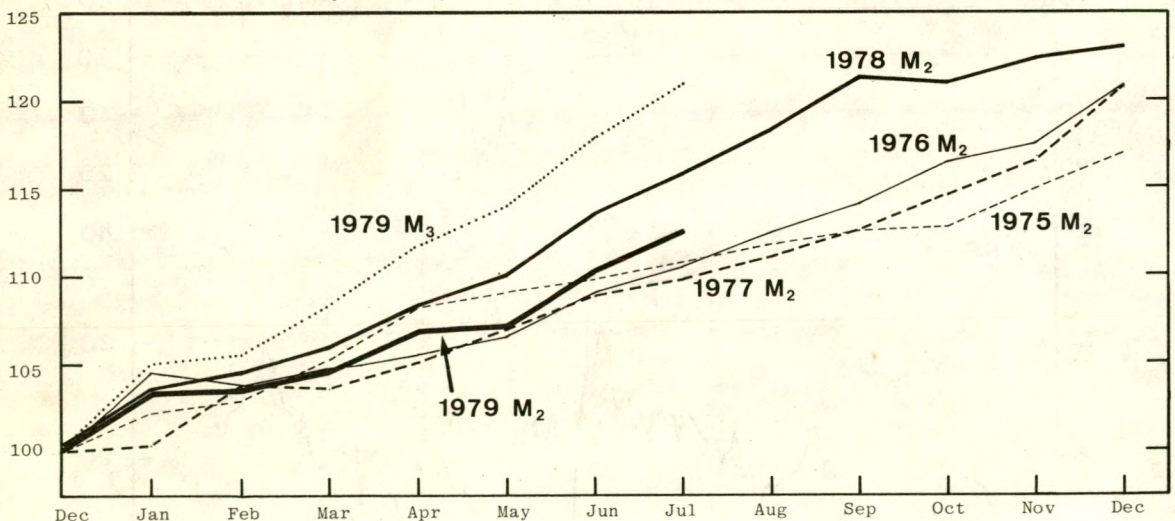


%RS - Percentage Rate of change over Same period of preceding year

Subsequently with the abandonment of the pegged exchange rate in November 1974 monetary expansion as measured by M_2 got under way, accelerating fairly continuously until September 1978. Inflation remained low through 1976-78, but has recently gained momentum rising from 4% in June 1978 to 12% in June 1979 on a year-on-year basis.

In early 1975 and again through most of 1976 the Hong Kong dollar appreciated against the U.S. dollar, presumably helping to keep at bay any expansionary effect of a balance of payments surplus. Thus whereas countries like South Korea and Taiwan experienced a monetary expansion of 30-40% per annum in 1975-76, Hong Kong's experience was more muted. On the other hand, whereas those countries are now suffering balance of payments deficits and the deficits are also producing a contractionary effect on their domestic monetary growth, Hong Kong is not experiencing any such monetary slowdown. Monetary growth on the broad M_3 definition remains very rapid (see Chart 6).

CHART 6
Comparison of Monetary Growth Rates since 1975



' M_3 ' equals M_2 plus deposits of DTC's minus DTC's holdings of cash.

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SUMMARY AND FORECAST: In Hong Kong the automatic adjustment mechanism operated until November 1974 as a powerful tool keeping Hong Kong's prices in line with prices overseas, and thus ensured that Hong Kong remained competitive in international markets. Since 1974 those countries like Taiwan and South Korea which have maintained a pegged exchange rate with the US\$ first experienced a strong expansion in 1975-77 and are now entering the contractionary phase of the cycle, so that in time their inflation rates will decline and they will once again become more competitive at current exchange rates. Hong Kong, however, is now largely insulated from the contractionary effect of the old automatic adjustment mechanism by the depreciation of its exchange rate, and therefore the economy is continuing to grow very strongly. Because the banks and deposit-taking companies are not being compelled to cut back on credit expansion as they would automatically have been obliged to do under the classical adjustment mechanism, the economic expansion has not been checked. Provided the spread between the banks' cost of funds and their lending rates remains positive, and provided they can continue to meet their Specified Liquid Asset ratios without difficulty, there is ample incentive for banks and other financial institutions to continue to create bank credit, the counterpart of which will be continuing monetary growth.

For whereas before November 1974 the exchange rate determined both the money supply (through the effect of the balance of payments on bank reserves) and hence the price level, since then the exchange rate on the one hand has been set free and the growth of the money supply on the other is now independently determined. In other words, the growth of bank credit is now a discretionary matter determined largely by the banks, while the adjustment of the overall price level in Hong Kong to prices overseas occurs through changes in the exchange rate. Unless there is a major recession in Hong Kong's overseas markets, any slowdown is likely to be mild, and even then the probable depreciation of the Hong Kong dollar and continuing domestic credit expansion would sustain the level of domestic economic activity rather than providing the old-style 'automatic' correction. Thus whereas Hong Kong prices stabilised abruptly in 1974-75 giving Hong Kong a strong competitive edge for the 1975-76 upturn, even if there is a downturn in 1980 the inflation will not be 'automatically' corrected under present monetary arrangements.

HONG KONG — APPENDIX

THE MONETARY IMPLICATIONS OF MOVING FROM A FIXED EXCHANGE RATE TO A FLOATING RATE

FIGURE 1

Under the fixed exchange rate system, the price of Hong Kong currency was fixed in terms of sterling. The quantity of currency (or money) was free to vary, but since there was only one amount of money that was compatible with a given level of economic activity and the demand for money, the money supply (the quantity) adjusted to the fixed exchange rate (the price), yielding an overall price level which was in line with prices overseas.

FIGURE 2

When the Hong Kong dollar was unhitched from sterling and pegged to the US dollar, a band was introduced on either side of the pegged rate within which the exchange rate could move. This introduced more potential variability to the money supply because now numerous possible amounts of money supply were compatible with the state of economic activity and the demand for money. The money supply (the quantity) still adjusted to the exchange rate (the price), but the number of possible solutions meant that the price level could wander further from price levels overseas so that the corrective mechanism was no longer so strict.

FIGURE 3

When the fixed exchange rate was abandoned in November 1974 an infinite number of combinations of money supply became compatible with a given state of economic activity and the demand for money. Now instead of the money supply adjusting to the exchange rate, the exchange rate (the price) adjusted to the money supply (the quantity).

FIGURE 4

If to this reversal of the equilibrating process is added a banking system which allows banks to create new reserve assets simply by borrowing abroad or bidding down the exchange rate, then the quantity of money can increase indefinitely and the exchange rate will move downwards to adjust the overall level of prices in Hong Kong to the overall level of prices in foreign countries. The exchange rate is now adjusting to:

- (1) the money supply created in Hong Kong and the resultant domestic price level (or expected price level), and
- (2) price levels overseas.

The rate of depreciation of the Hong Kong dollar therefore depends on the rate of excess money creation in Hong Kong and the inflation rate overseas. Under the old automatic adjustment mechanism if there was no (or low) inflation in the US or Britain, then Hong Kong prices were stable. Under the present mechanism there is no such assurance.

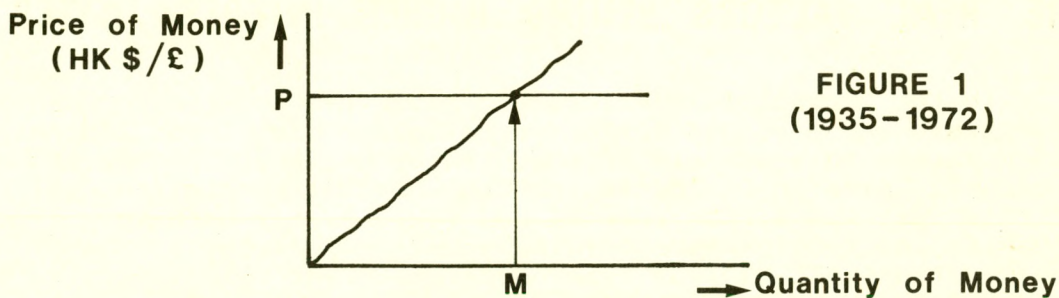


FIGURE 1
(1935-1972)

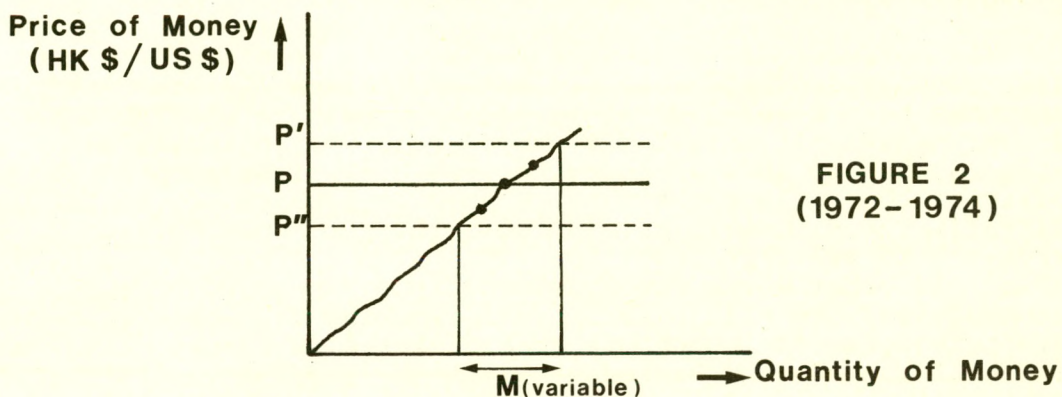


FIGURE 2
(1972-1974)

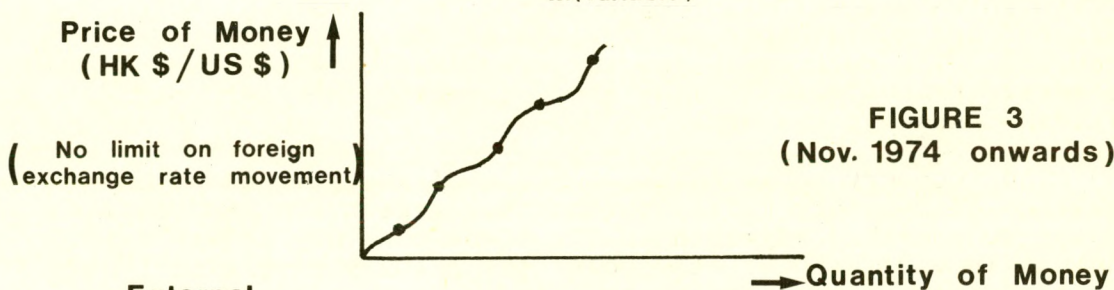


FIGURE 3
(Nov. 1974 onwards)

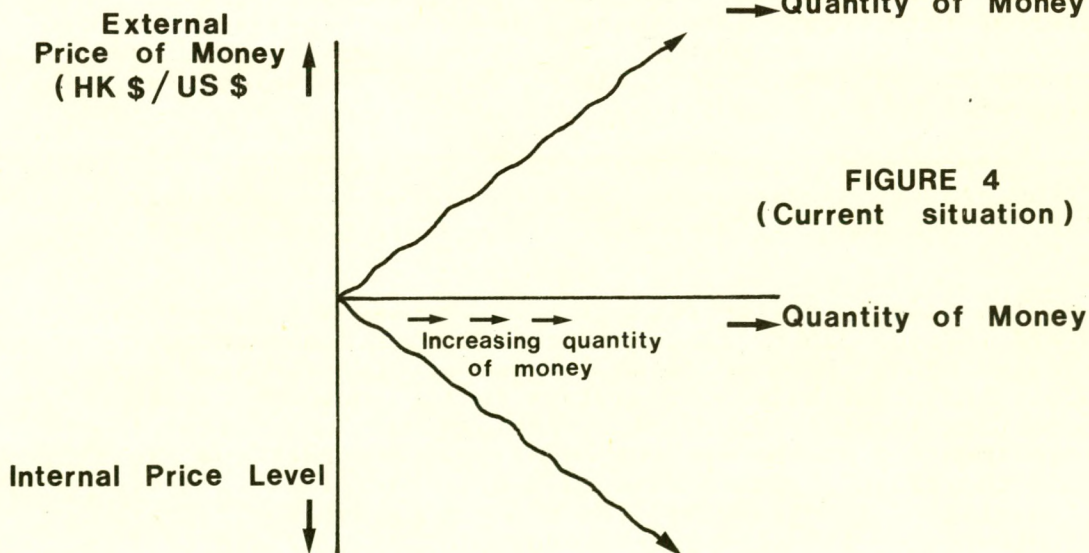


FIGURE 4
(Current situation)

JAPAN

THE 'REAL' FACTORS BEHIND HIGHER INTEREST RATES

In the summer of 1978 interest rates reached their lowest levels since the Second World War following one of the longest and greatest bull markets in bonds which began in 1974. The subsequent rise in yields in the long-bond market in the spring of this year was a rude reversal of fortunes for both the domestic and foreign investor in Japan. From a low of 6.4% in 1978 the yield on long term corporate bonds rose to 8.3% by June 1979.

The movement of interest rates must be seen against the background of Japanese monetary policy. Since 1977 the Bank of Japan has been keeping M_2 at an annual growth rate of around 12% per annum. In actual fact the period should really be extended back to 1974 when the central bank first adopted the policy of controlling the money supply as its primary objective. Initially the M_2 growth rate of only 12% per annum collided harshly with the high inflation expectations prevailing in Japan. In other words the money supply was prevented from accommodating the high rate of inflation and as a result in the ensuing squeeze real economic growth virtually ceased. It was not until the economy had adjusted to the new low monetary growth rates and inflation expectations had subsided, that a balanced and sustainable recovery in economic activity occurred. The recovery began in early 1978 by which time wholesale prices were falling and consumer prices were rising at less than 4% per annum.

The recovery occurred not because of any stimulatory 'easing' of monetary policy but because wage/price expectations in the economy had adjusted to the lower monetary growth rate. Whereas in earlier business cycles the primary determinant of interest rate trends were changes in the rate of growth of the money supply, in the present cycle developments in the 'real' economy are of greater importance, and changes in monetary growth rates will be less significant.

As economic activity strengthens and the demand for credit by the private sector grows, interest rates are being allowed to rise but the quantity of money is not being permitted to grow faster.

The history of the present recovery and its effect on interest rates can be traced in the flow of funds accounts produced by the Bank of Japan. These accounts analyse the supply and distribution of savings in the economy. As an accounting identity the flow of savings must equal the flow of 'investment' i.e. the new borrowing in the market for capital. It is therefore a nonsense to talk of a 'surplus' of saving or a 'shortage' of investment, the two are always equilibrated by adjustments to interest rates, economic activity and the balance of payments. However the relative shares of various sectors in the total of invested funds and in the contribution to savings provide clues to the overall pressures on credit markets.

The government sector is perhaps the most interest-inelastic borrower of funds. Credit demand by the government is determined primarily by fiscal policy, not by the cost of credit. It follows that the other sectors of the economy take more of the burden of adjusting to the fluctuation in the supply and demand for funds. The largest contributor of savings and the only sector to show a consistent financial surplus is the personal sector, where household savings play a major role. The flow of personal savings, like the government borrowing requirement, appears to be relatively insensitive to interest rate changes and the financial surplus of the personal sector has grown at a fairly predictable rate over the years. The two remaining major sectors, the external sector and the corporate sector in consequence show greater variations in their credit demands associated with the business cycle.

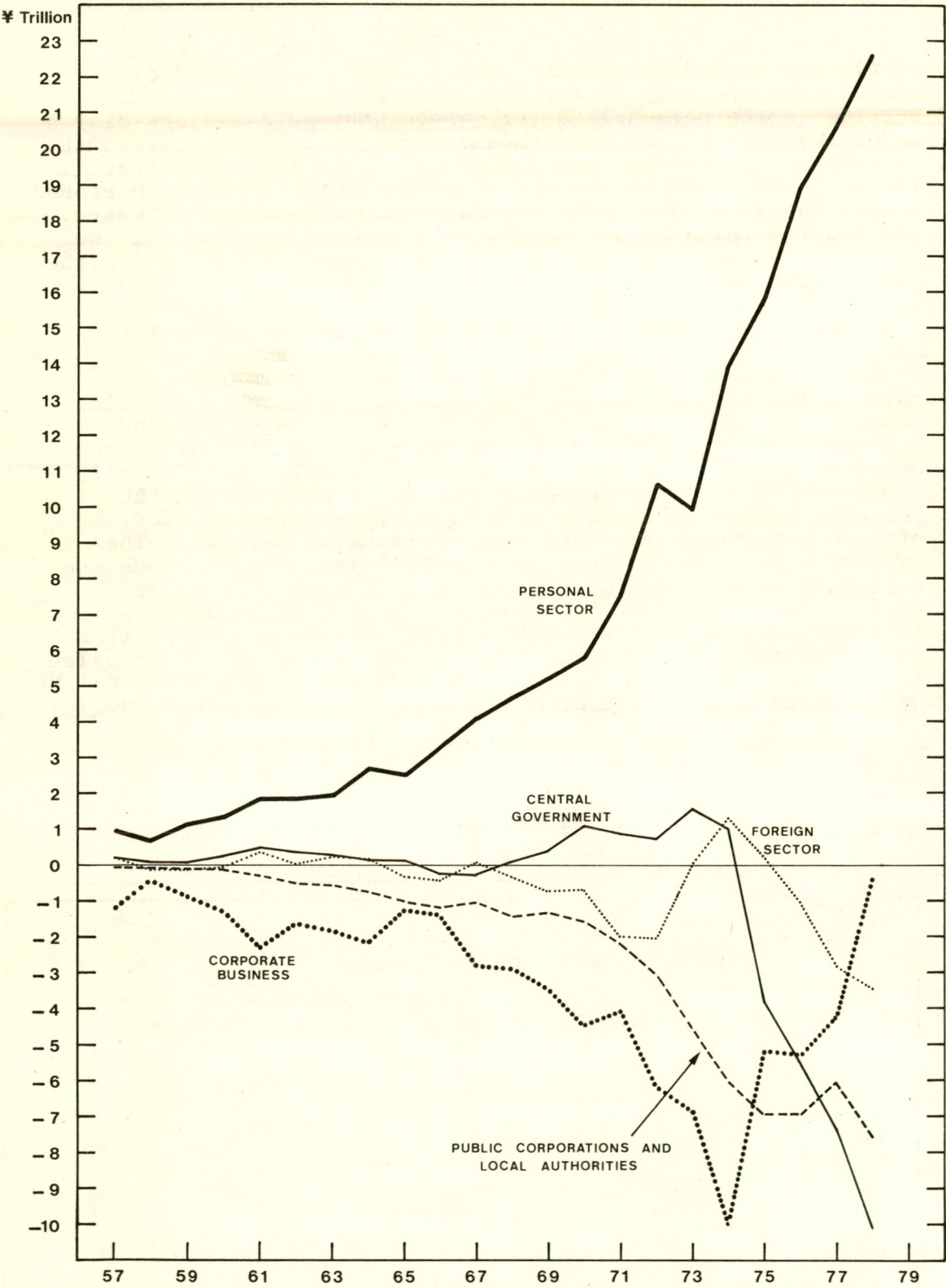
The financial deficit of the corporate sector declined markedly in the post oil-crisis years as is fairly typical of a period of cyclical depression when investment is low and inventories are declining. The fall in the corporate deficit was however very much greater than in previous cycles and represented a major retrenchment and restructuring of corporate balance sheets. The falling corporate deficit was not fully compensated for by the growing government deficit and the residual demand for credit came from the external sector; in other words, there was a balance of payments surplus. The corporate deficit declined continuously from 1974 onwards and continued into the first quarter of 1978 when the economic recovery got under way. In the second and third quarters of 1978 the corporate sector even showed a surplus - a position unprecedented since flow of funds accounts were first compiled. This reduced corporate deficit was mirrored in a growing balance of payments surplus - i.e. an expanding external sector deficit.

TABLE 1

Flow of Funds by Sectors (Seasonally adjusted)

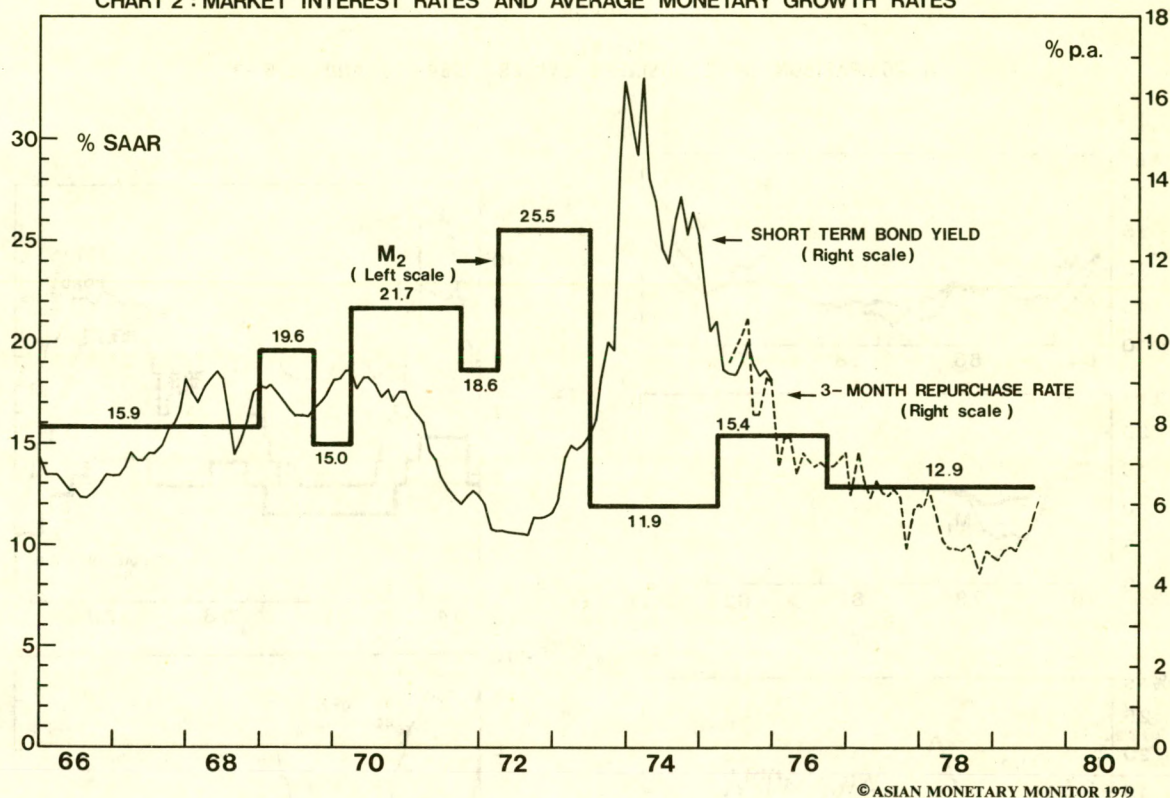
		¥ bn					
		Central Govt.	Other Govt.	Total Govt.	Corporate Sector	Personal Sector	Rest of World Sector
1977	I	- 1215	- 1573	- 2788	- 549	3720	- 490
	II	- 2295	- 1177	- 3472	- 1735	5726	- 642
	III	- 1631	- 1283	- 1543	- 785	4673	- 823
	IV	- 2899	- 2364	- 6218	- 1612	7906	- 978
1978	I	- 1851	- 1780	- 2164	- 101	5060	- 1142
	II	- 3528	- 2036	- 6625	530	5741	- 1026
	III	- 2752	- 1713	- 4465	1057	5228	- 971
	IV	- 2689	- 2056	- 4745	- 1870	6533	- 357
1979	I	- 1289	- 1840	- 3129	- 558	3845	- 64

CHART :1
JAPAN: FLOW OF FUNDS BY SECTORS (Annual data)



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JAPAN
CHART 2 : MARKET INTEREST RATES AND AVERAGE MONETARY GROWTH RATES



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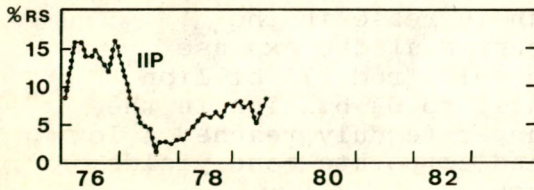
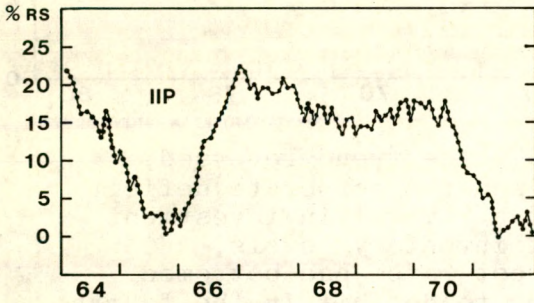
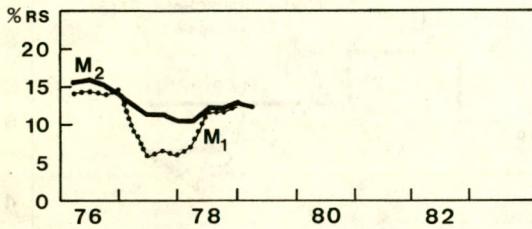
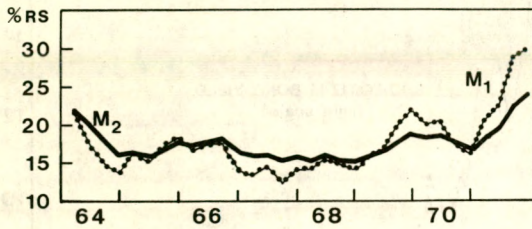
Then in the final quarter of 1978 the trend reversed, corporate demand for funds revived, and the corporate deficit expanded again. This coincided with a revival in investment expenditure and the stabilization of inventory levels, and it was a clear signal that interest rates had bottomed. The reversion of the corporate sector to deficit in the fourth quarter of 1978 was facilitated by an increase in the personal sector surplus but also occurred at the expense of the external sector deficit which fell from 971 billion yen to 357 billion yen and subsequently to 64 billion in the first quarter of 1979. The call money rate duly reached a low of 3.9% in November and government and corporate bond yields turned upwards in February of this year.

The Bank of Japan could have attempted to keep interest rates down in the short term by supplying extra funds to the banks but this would have sacrificed their money supply targets, so instead interest rates were allowed to rise and the Bank of Japan's own official discount rate has been raised in line with market trends. By adhering to the primary goal of monetary stability and thereby preventing a serious acceleration of inflation, the authorities were in fact ensuring that the general level of interest rates will remain low in the longer run.

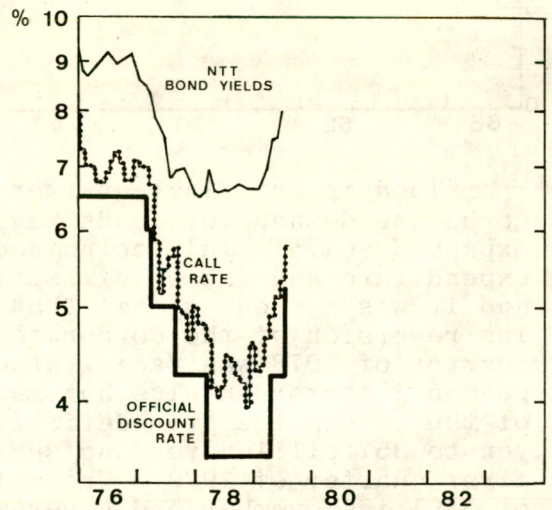
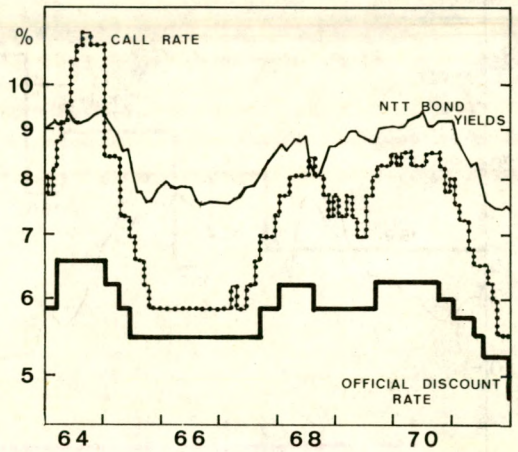
The pattern of interest rates during business cycles in the past was the outcome of the interaction of private sector credit demands and the policy responses of the central bank. This time it is likely that the authorities will be less responsive to private sector credit demand, pursuing instead a policy of steady monetary growth. Because of this new policy

JAPAN

CHART:3
A COMPARISON OF 2 BUSINESS CYCLES: 1964-70 AND 1976-?



IIP: INDEX OF INDUSTRIAL PRODUCTION



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past business cycles are likely to be a poor guide to interest rate trends today unless the earlier periods considered also were characterised by a relatively steady monetary growth rate.

A Historical Precendent For The Current Cycle: 1964-1970

Fortunately there is one such period in the late sixties when the money supply M_2 grew at a steady rate of 16% per annum for nearly five years. ² Although such a rate is rather higher than the current 12% rate it was matched by a correspondingly higher rate of real economic growth (about 12% compared with about 6% today) and inflation remained at a low level throughout the latter half of the decade.

The period from September 1964 to July 1969, when the money supply grew at a very steady rate, can be divided into four sections:

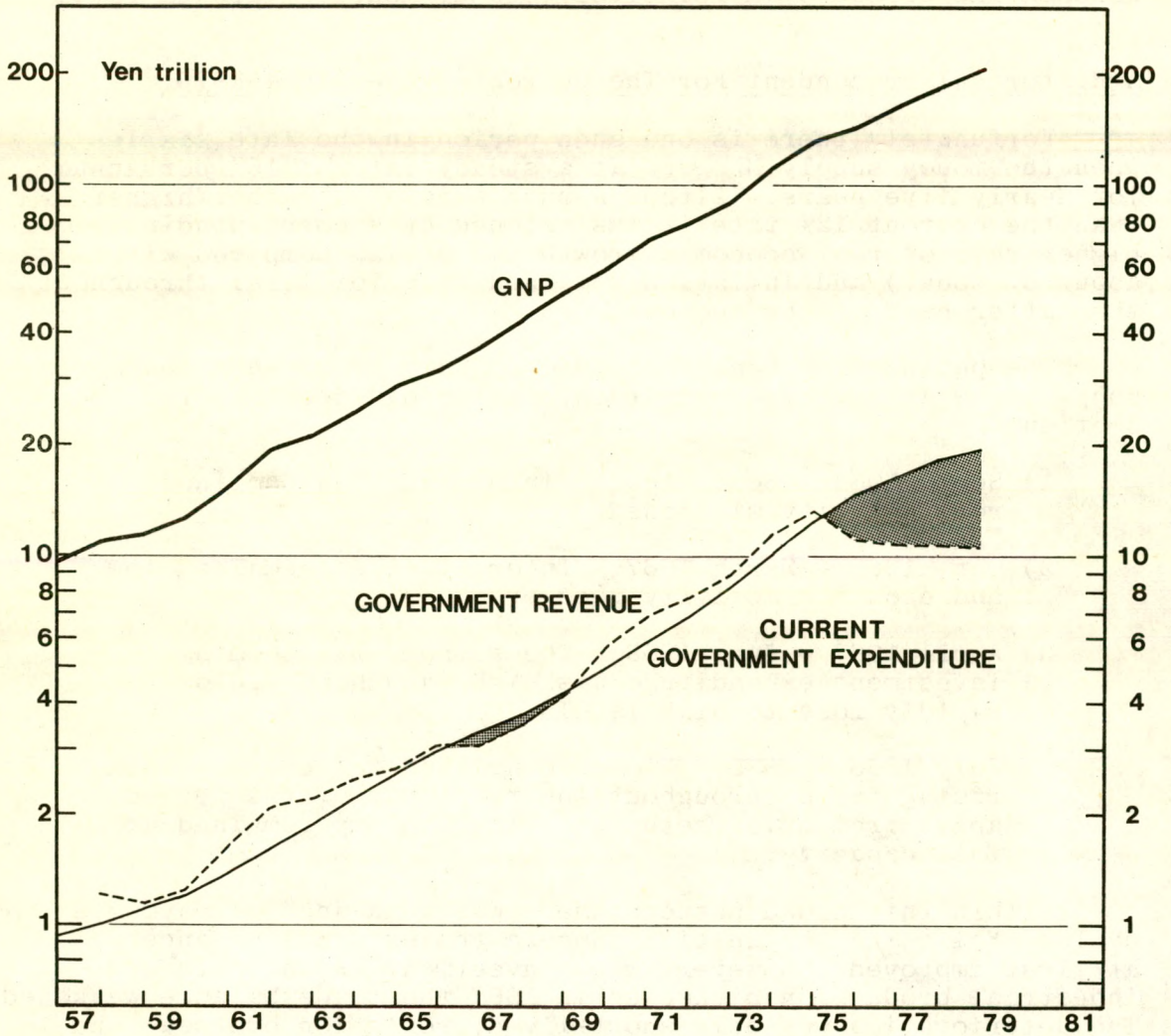
- 1) Sept. 1964 - Sept. 1965. Interest rates declined, real activity slackened.
- 2) Oct. 1965 - March 1967. Interest rates remained low and economic activity recovered.
- 3) April 1967 - June 1968. The economy was booming, investment expenditure was high, and bond yields rapidly rose to high levels.
- 4) July 1968 - 1970. Yields continued to show a gradual rising trend throughout the remainder of the period, apart from brief setbacks. The economy remained at full capacity.

Within this broad pattern there was a balance of payments cycle. Following the initial squeeze the external balance at first improved. However, when investment expenditure and industrial production picked up in 1967 the trade balance weakened. The deterioration was only short-lived; reflation overseas and higher interest rates at home restored the balance by summer 1968; and the external accounts remained in surplus until 1970. In response to these changes on the external account, short term interest rates rose and fell accordingly as the foreign balance was weakening or strengthening but long bonds, apart from short rallies, followed a trend determined mainly by aggregate domestic economic activity.

In the present cycle the economy appears to have just completed the third stage of the interest rate cycle described above, when there is a rapid rise in both long and short rates to new levels as the economy comes to full capacity and the external account weakens. Assuming there is no serious deterioration in the underlying inflation trend (as a stable monetary policy would imply), interest rates may be expected to stabilize or increase gradually from their present levels over the next year, but no prolonged fall is in prospect since economic activity will remain buoyant. By the same token a rapid escalation of rates is also not likely.

JAPAN

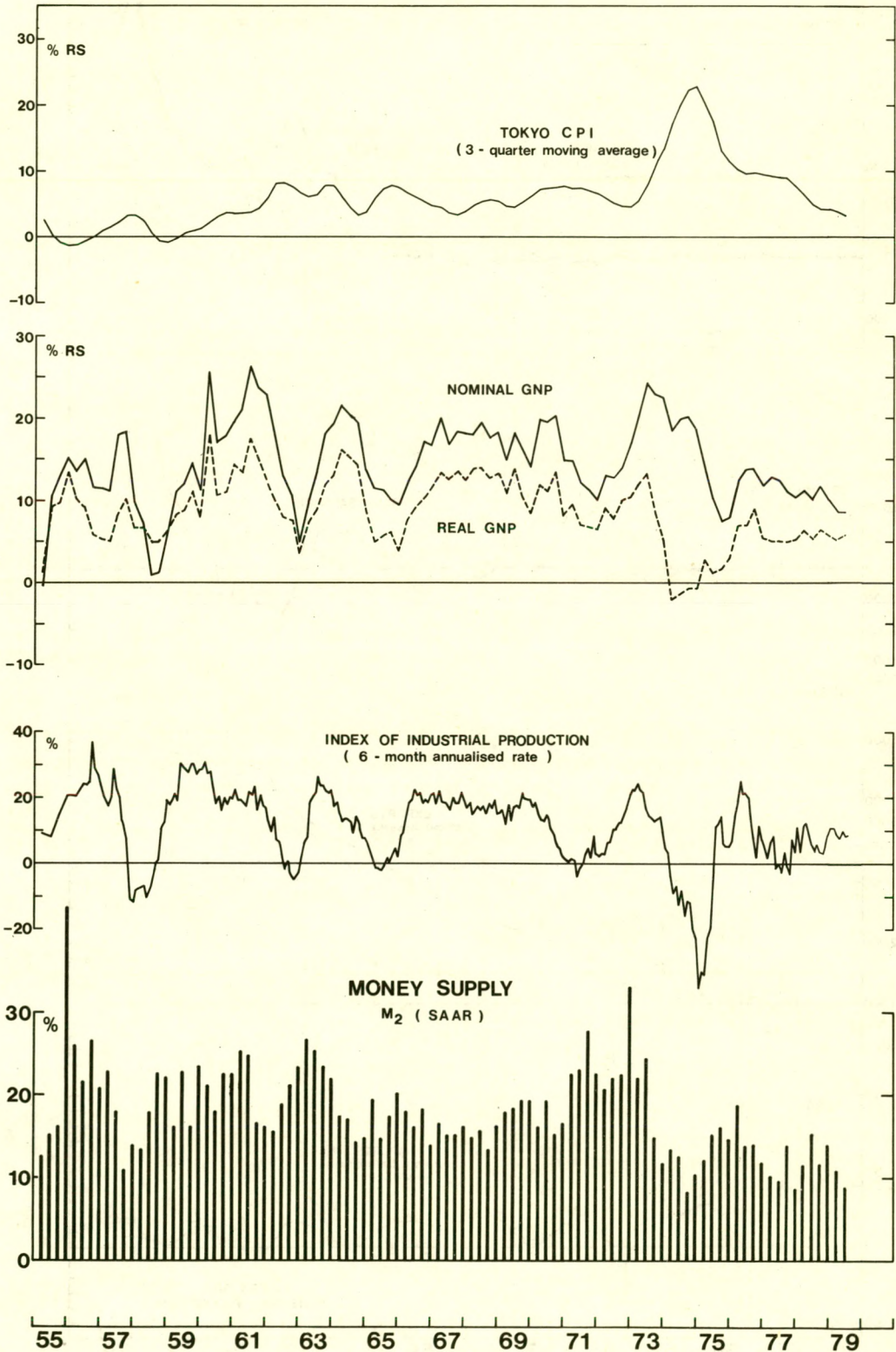
CHART 4 : GNP AND GOVERNMENT REVENUE AND EXPENDITURE



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JAPAN

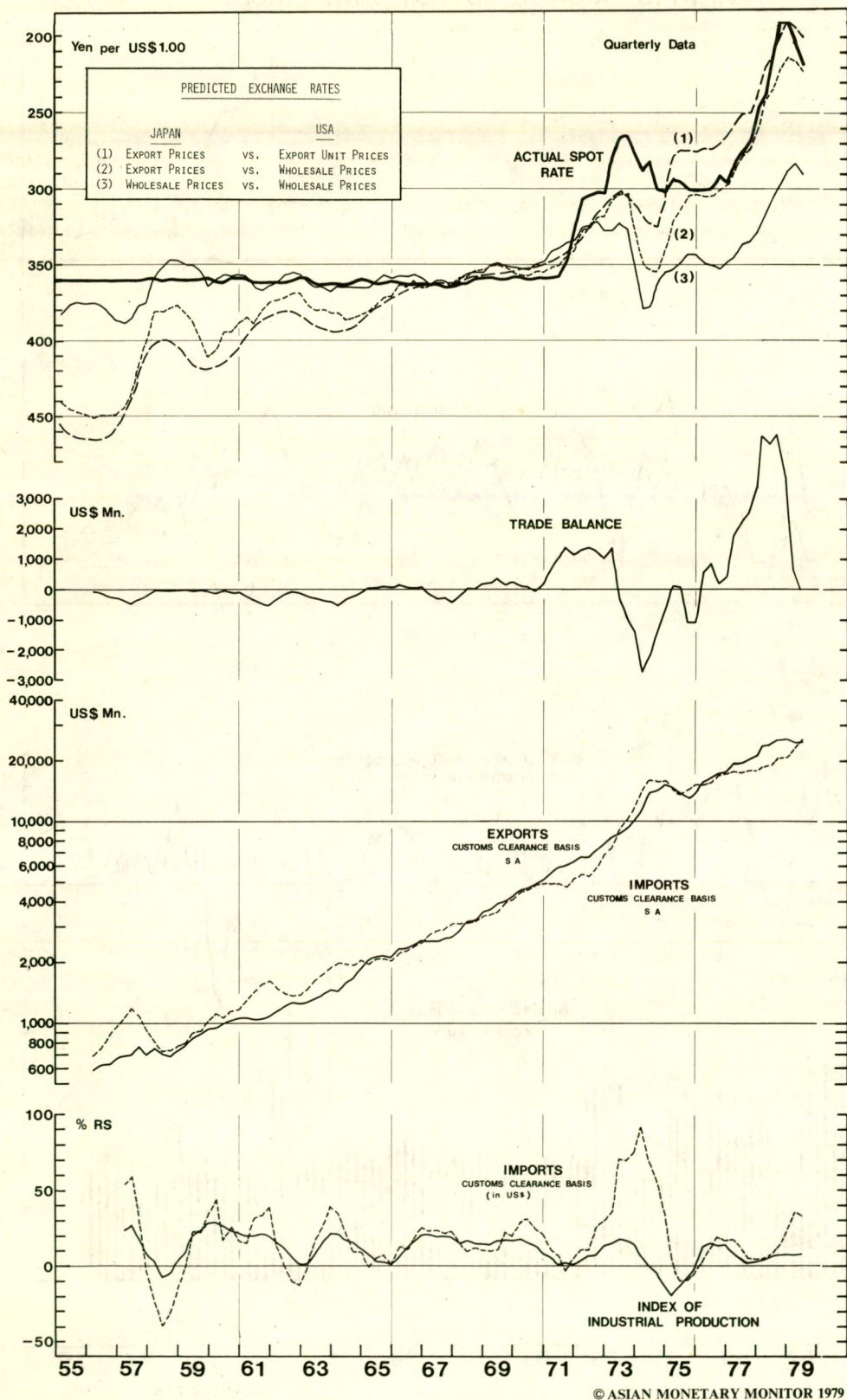
CHART 5 : MONEY, OUTPUT, AND PRICES



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JAPAN

CHART 6 : EXTERNAL TRADE, RELATIVE PRICES AND EXCHANGE RATE



The balance of payments may also go through a similar cycle to that in 1964-69, although for slightly different reasons. Following the large depreciation of the yen against the dollar from 180 yen to 220 yen per dollar in the past year the deterioration in the trade balance may be arrested. Export letters of credit and other indicators suggest that exports may revive in the latter half of 1979. If so, upward pressure on short-term rates will remain around this new higher level in line with the continued high level of economic activity.

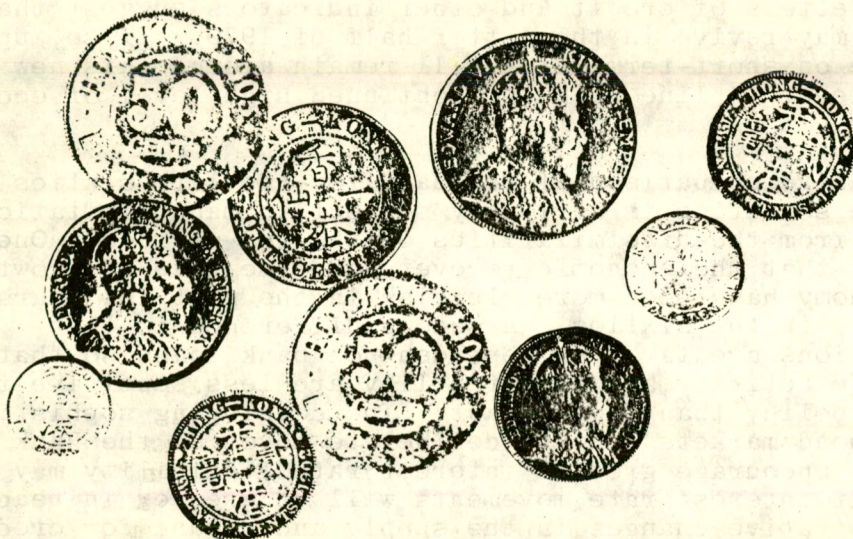
A naive comparison of the data for the late sixties and the late seventies is obviously subject to many limitations arising from the dissimilarities of the two periods. One is the fact that the economic recovery and the rate of growth of the economy have been more sluggish in the past few years than they were in the sixties. A second difference is that corporations are far less dependent on bank loans so that corporate activity and profitability are less sensitive to bank lending policy than in the past. The developing sophistication of the bond markets and the deliberate moves by the Bank of Japan to encourage greater interest rate flexibility may also mean that interest rate movements will be greater in reaction to quantitative changes in the supply and demand for credit than was the case in the sixties.

Nevertheless, the lesson of the sixties may be summarised as follows: when long run inflation expectations are stable and monetary growth is not excessive interest rates do not rise continuously throughout a cyclical economic expansion. After a period of initial recovery when credit demand is slack and interest rates are low, there appears to be a readjustment to a higher plateau of rates which reflect the strength of credit demand in an economy growing 'at full capacity'. Interest rates do not then continue to rise because inflation remains at a low rate.

FORECAST: In so far as monetary policy in 1979 resembles monetary policy in the late sixties a similar interest rate pattern can be expected. The trend of interest rates will be largely independent of the balance of payments or of interest rates overseas. Now that the economy is growing steadily and capacity utilization is rising to pre-oil crisis levels bond yields can be expected to remain at the higher levels established in recent months.

EPISODES FROM ASIAN MONETARY HISTORY

HONG KONG: CASHING IN ON SMALL CHANGE



In 1978 Hong Kong suffered from a shortage of small change. For many months it was common to see long queues of office boys and shopkeepers at the banks attempting to obtain sufficient supplies of small change to conduct their daily business. The official explanation of the shortage was that the public's demand for 10, 20 and 50 cent pieces had increased suddenly because of the growing use of slot machines and increased bus fares. Adding to the problem, a ship bringing the latest consignment of small coins from the Royal Mint in Britain was delayed so although extra supplies of coinage were ordered, it was several months before the shortage was eliminated.

This little episode was by no means the first to trouble the subsidiary coinage of the colony. In the late nineteenth century the lack of small change was a serious problem which eventually led the colonial government to import its own subsidiary coinage from Britain to supplement the deficient and erratic supply of small coins from mainland China.

At the turn of the century the currency of China was in a chaotic state; silver dollars from Mexico and Bombay, yen from Japan, small Chinese ingots or 'sycee' of silver and local dollars of doubtful bullion content were all in circulation. The subsidiary coinage was primarily in the form of copper 'cash' a very low value coin which was little more than a copper disk with a square hole in it. One silver dollar was equivalent to several hundred cash, but the exact exchange rate depended on the relative prices of copper and silver. Because the cash had so little value they were usually threaded together on a string for convenience, but they were a heavy and cumbersome form of currency.

This unsatisfactory state of affairs led the Hong Kong authorities to introduce their own small change. In Hong Kong the silver dollar was divided into 100 cents and subsidiary coins, denominated in cents, were issued by the government. These light coins, particularly the silver twenty cent pieces, proved very popular both in China and Hong Kong because they were much more convenient to carry than the heavy strings of cash. Although it was estimated in the first decade of this century that Hong Kong's domestic requirements of subsidiary coins amounted to only HK\$2 million, by 1906 nearly \$44 million worth of coins had been issued. The great excess of coinage had been absorbed by the mainland.

Whereas the cash were valued by their bullion content, i.e. by their weight of copper, and therefore varied in value against the silver dollar accordingly as the price of copper fluctuated against the price of silver, the cents issued by the Hong Kong government were fiat coinage depending for their value on the implicit government guarantee to redeem them in dollars at face value (one hundred cents to the dollar) although their bullion value was much lower. Thus the Hong Kong government made a considerable seignorage profit from minting the subsidiary coins and the more that went into circulation, the greater the contribution to the government's revenues. The colonial government was thus happy to reap the seignorage profit of providing a substantial part of the circulating currency of the neighbouring Kwantung province. Even though the small coin issue was wildly in excess of Hong Kong local requirements the Chinese demand for them was so great that at times the small coins stood at a premium to face value.

Then in 1906 the situation reversed and the subsidiary coinage fell from a premium on face value to a discount which soon became quite heavy. An inquiry was set up and a Subsidiary Coin Committee was appointed in 1907 which reported that the decline in value of the Hong Kong cent was due to both the over-issue of Hong Kong currency and the growing circulation in the colony of subsidiary coins struck at the Canton Mint.

The Canton Mint had opened in 1888 to mint silver 'dragon' dollars, but observing the popularity of the Hong Kong subsidiary coinage in Kwantung province, the mint soon redirected its efforts into the more profitable activity of minting its own subsidiary coin. Whereas silver dollars, which were valued by their bullion content, provided no opportunity for seignorage profits, the subsidiary coinage did, and the mint soon lapsed from minting the former into an over-production of the latter, particularly the silver twenty cent pieces for which there was a keen demand. Before long the new Cantonese issues of subsidiary coinage had more than satiated demand and the coinage fell to a discount on face value.

The Canton issue circulated freely and interchangeably with the Hong Kong issue in the colony, so the over-issue of the Chinese money had the effect of discounting the local issue as well. Several attempts were made to induce the Canton mint

to stop issuing subsidiary coin but to no avail. By 1916 the Canton twenty cent pieces were discounted almost to their bullion value and they were even shipped to Shanghai as silver bullion during World War I.

Since the Canton mint could not be made to stop minting, the Hong Kong government stopped instead and in 1906 began to withdraw all subsidiary coin which happened to be paid to the Treasury in the course of government transactions. This action had little effect since coins quickly flowed back into the colony from the mainland and the discount persisted.

The problem of the depreciating small change was the same as the familiar problem of trying to peg exchange rates when the authorities in different countries follow divergent monetary policies. The Hong Kong twenty cent piece was 'pegged' to the Cantonese coin, but the Hong Kong authorities were attempting to contract the supply while the Cantonese mint was happily expanding the supply. Just as such policies eventually lead a fixed exchange rate to break down and to a devaluation of the relatively more abundant currency, the strains began to tell on the subsidiary coinage of the region.

The government continued to demonetize small change after 1906 but as the policy was pursued through the following four years with little apparent effect on the discount, the authorities lost conviction and temporarily ceased the demonetization in 1911. But the matter was not to rest there, in 1912, under the encouragement (or so it is believed) of the new Governor, Sir Henry May, the Hong Kong Tramway Company made the first move to break the inter-convertibility of Hong Kong and Canton subsidiary coinage by refusing to accept the Cantonese coins. There was an outcry from the Chinese. It was of course in the interests of the travelling public to be able to pay the tram fares in the 'cheap' Chinese currency at parity with Hong Kong currency and thereby pay in cents which were worth rather less than one-hundredths of a dollar. Apart from this 'Gresham's Law' effect whereby payment in 'bad' money was preferred to payment in 'good' money, there was also a consideration of patriotic pride: the refusal to accept Chinese coins was seen as an insult to the newly installed National Government which had so recently replaced the Manchu Dynasty. A boycott of the Tramways was accordingly declared.

In order to break the spell, the tram company gave free rides to lure people back onto the trams; but the boycott continued and although the free rides were happily taken, no payment could be induced from the Chinese. The Company faced with mounting losses, thereupon appealed to the Governor.

"The matter had now assumed the aspect of an attack not on the Tramway Company but on the Government, and Sir Henry tracing the centre of boycotting activity to a particular district of the town, flung down the gauntlet in the form of a Boycott Prevention Bill. This Bill imposed upon the chosen district a special punitive rate. It served its purpose and, within a day or two of its publication, Hong Kong witnessed the happy spectacle of the Chinese members of Legislative Council mounting a tram and

indicating to the world at large that tram-riding was fashionable again. The boycott thus came to an end and the Tramway Company received from the Government forty-five thousand dollars as compensation for loss of custom."*

Shortly afterwards, in July 1913, the government passed an ordinance confirming the currency schism by forbidding the use of notes and coins other than those of the Colony.

Perhaps strangely, the discount on the Hong Kong cents remained. The only effect of the Ordinance was to draw Hong Kong coinage from Canton to displace the Cantonese coinage which was no longer legal tender in the colony. In the following years the Treasury continued to withdraw subsidiary coinage from circulation and by 1919 \$26 million of the original issue of \$44 million had been withdrawn and the discount had vanished. Although Hong Kong bronze one cent pieces were struck once more in 1919 after a lapse of fourteen years, the surfeit of silver coinage was enough to supply the colony's needs until 1932.

* The quotation comes from page 114 'Hong Kong 1862-1919 : Years of Discretion' by G.R. Sayer, Hong Kong 1975. The problems of subsidiary coinage are also discussed in an article by W.J. Hinton: 'A Note on Some Anomalies in the Currency of Hong Kong' written in 1918 but appearing in 'Readings in Economics for China' edited by C.F. Remer, Commercial Press Shanghai 1933.

BOOK REVIEW

"Cambodia Year Zero" by F. Ponchard. Allen Lane, London, 1977.

"Peace with Horror" by J. Barron and A. Paul. Hodder and Stoughton
London, 1977

The successful Vietnamese invasion of Cambodia at the beginning of this year marked the end of perhaps the most horrifying regime of the post-1945 era. For the Khmer Rouge leaders were not simply twisted savages in the Amin mould. Rather, they were rigorous ideologues, sharing a common background as students in France during the 1950s, and determined to impose their vision of social organisation on the war-wrecked people of Cambodia. The result was the negation of economic progress as well as the destruction of Khmer civilization. Yet, curiously, the world's reaction has been strangely muted.

These two books constitute a large part of the available literature on what actually happened following the Khmer Rouge takeover in April, 1975. Both were published in 1977 before the subsequent breakdown in relations between Vietnam and Cambodia, and both are primarily concerned with chronicling the unprecedented suffering endured by a people only just relieved from the turmoil precipitated by the extension of the Vietnamese conflict into its Indo-China neighbour, and with it all the horrors of B-52 bombing. Both rely primarily on refugee accounts, since these are the only non-governmental source of information on what was actually taking place in one of the world's most closed societies. True, such refugees may be biased, but the very number who had managed to escape over the Thai and Vietnamese borders allowed the authors to countercheck scrupulously all information, as well as to interview a diverse section of Cambodian society.

The principal feature of the Khmer Rouge revolution lies in the compulsory evacuations which immediately followed the collapse of Lon Nol's government, most notably from Phnom Penh, a city at the time of 3 million. Apologists for the regime have concluded that such action was dictated by the threat of mass starvation. In fact, both these books illustrate that the decision was planned and primarily ideological. The Khmer Rouge wished to 'annul the past'. Towns, the pivot of successful capitalist endeavour, and the attendant mushrooming of goods and services to fit all demands, had no place in the new self-sufficient 'Democratic Kampuchea'.

Barron and Paul go into much detail in recording the individual experience of Cambodians, be it mass executions, the relentless toil of the ubiquitous village collectives with their regimental work programmes, or the drama of escape attempts over the border. However, Ponchard, a French Jesuit who himself spent 10 years in Cambodia right up until April 1975, is the more penetrating. He incorporates the account of the individual suffering with an analysis of the economic ordering of the new society, gleaned both from refugee sources and the government radio, 'The Democratic Voice of Kampuchea'. We learn that the Khmer Rouge did not only destroy urban life.

With it, went money, foreign medicine and technology, especially if of American or Western European origin. The reserves of the central bank were burnt on the taking of Phnom Penh, and paper money declared redundant. Socialist development demanded the return to a system of barter. Yet even bartering was denied the mass of workers in the countryside. There the penalty for barter was death, the dreaded call to the 'Angkar Loeu', the 'Higher Organisation', while the only income won from the unrelenting 7 day labour was a precarious ration of rice.

Such a reversal of economic development coincided with the 'atomisation' of society - the rule of fear, the threat of the informer, a role usually undertaken by children, and the forced break-up of the family.

In the months that followed the evacuations a more ordered collectivisation of agriculture occurred, reflected first in the growth of the 'new villages', then in the emergence of 'state farms', where the entire production went to the State, and finally the development of 'worksites' on a military model, where effort was concentrated on restoring the vital classical irrigation system destroyed during the War, in a country where the monsoon was both too heavy and too short. Ponchard points out that the new rulers conceived of the economic process primarily as a 'struggle' for rice production and the control of water in the form of dike and dam construction. Yet the struggle had to occur within the constraint of absolute self-sufficiency. Hence the refusal of foreign aid (except from the Chinese), the stories of men and women pulling ploughs or digging with their own hands, and the absolute determination to force all into the fields. With the outlawing of money went the division of labour, professional competence and the other vestiges of technological culture. The rubber plantations, a French colonial legacy, remained unproductive, while trade was at a minimum despite the existence of a trading outlet in Hong Kong, the Pen Fung Company, set up in late 1976, with the aim of dealing with non-socialist countries under the cover of a Chinese bank.

Not surprisingly, the Khmer Rouge could not organise an efficient allocative mechanism to supply the population when they rejected the laws of supply and demand. Instead, when food ran low, as it did, the workers in the fields were forced to ravage the surrounding jungle for their own needs. Everything was eaten, even the bark of trees, with resulting mass debilitation. Those who complained of illness were accused of suffering from 'memory sickness', and hankering after a decadent past. They were against the 'wheel of history' and as such liquidated.

It might be thought that the Khmer Rouge example merely represents a slavish devotion to Maoist principles carried to their logical extreme. Certainly, the Chinese were the sponsors of the regime. Yet, as Ponchard points out, Chou-en Lai tried to moderate the excesses of the Cambodian leaders. Moreover, the Maoist slogans of self-sufficiency and the primacy of agriculture were applied in a vast continent of enormous resources. In contrast, Cambodia is about one third the size of France and without mineral or industrial wealth.

The Khmer Rouge slogan - 'Independence-Sovereignty' - a favourite piece of jargon, stands then for the inexorable tendency of ideologues to push ideas to their logical limits, however impractical and however intolerable the consequences. In the Cambodian case, the preceding history, coloured by American involvement, generated a dangerous vacuum in which an introverted and unrepresentative clique were able to seize power, backed by Chinese aid and the legitimisation conferred by Prince Sihanouk's nominal support. The result was a new form of totalitarianism, in which the means of exchange, the basis of economic order, was abandoned in a puritannical thirst for purification.

Hopefully, these two books, concentrating as they do on the humanitarian aspect, will be supplemented by more detailed works. The problem is that, in defying the mechanisms of orthodox economics, the Khmer Rouge have destroyed not only Cambodian civilisation, but also much of the detailed evidence that a pervasive totalitarianism which denies the free exchange of resources and information also interferes with the division of labour on which economic progress depends.



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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

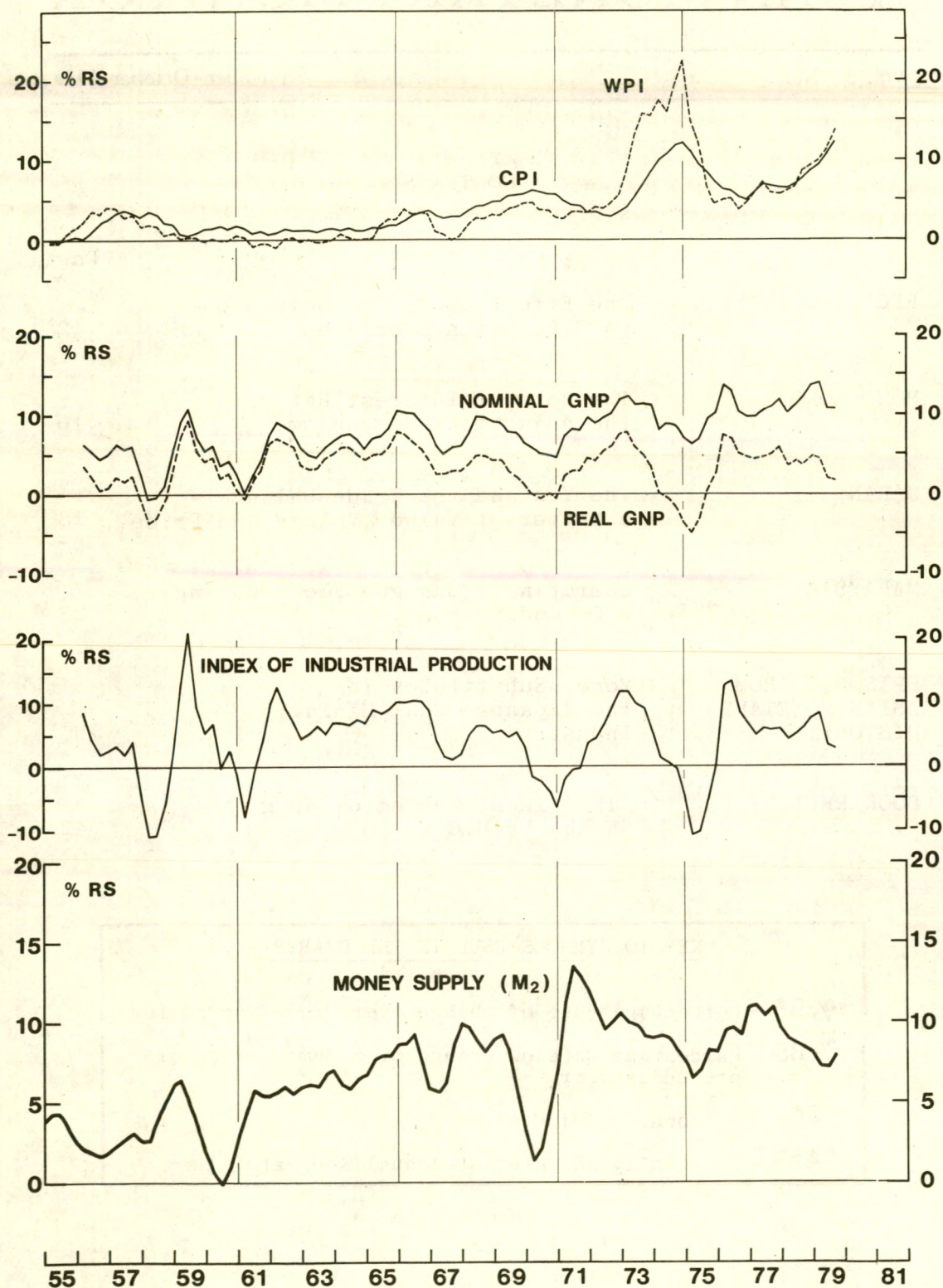
% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

U. S. A.

CHART 1 : MONEY, OUTPUT, AND PRICES



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REGIONAL SURVEY

THE EFFECT OF A U.S. RECESSION ON S.E. ASIAN ECONOMIES

The reorientation of monetary priorities in the United States announced by Mr. Volcker on October 6 now enables the Federal authorities to restrain the growth of domestic monetary aggregates. Assuming that the Federal Reserve does restrict money growth, this will be followed by a reduction in the growth of nominal GNP leading to a deepening recession in the United States. The effect of such a recession will be to reduce the demand for US imports thereby in part justifying the strengthening of the US dollar which has already taken place on the expectation of an improved US balance of payments and reduced domestic inflation. The result of a deepening recession is therefore to reduce the demand for the output of the Pacific Rim economies and increase the price of goods (e.g. oil) denominated in terms of the US dollar.

Although in most cases a sharpened US recession will induce downward pressure on the balance of trade in the Pacific Rim economies it is not possible to make any generalisations about the size or distribution of this reduction. The first reason for this is that although the Pacific Rim economies run a large trade surplus with the US, this surplus is distributed unequally. Thus even equal proportional reductions in imports from, and exports to, the US will have varying effects on the trade position within the region. The second reason is that the composition of trade with the US differs substantially between Pacific Rim countries. The composition of trade not only affects the trade balance through its effect on the aggregate price elasticity of demand for imports and supply of exports, but also through the direction of trade. Thus oil exporting economies such as Malaysia and Indonesia will gain some benefit from the effective increase in the price of oil.

The third and crucial reason why it is not feasible to generalise about the effects of a possible US recession is that any description of the medium term impact of such a recession on Pacific Rim economies is conditional on their domestic policy responses. Assume, for expository purposes, that the US dollar appreciates against all other currencies, and that the exchange rates between these remaining currencies stays the same. The increase in dollar priced goods has two effects. Firstly, it will tend to lead to the substitution of domestic production (for consumption both at home and abroad) for foreign imports. Since the reason for the increase in dollar prices is reduced American demand for imports this effect will be limited. Secondly the change in relative prices implies that the terms of trade (the amount of physical domestic production that can be exchanged for foreign production) have moved in favour of the US. In other words the rate of increase in real income of the Pacific Rim economies has fallen. If the US dollar appreciates against all other currencies, this change in the terms of trade will create a deflationary multiplier effect

leading to a once and for all real transfer to the US. This analysis will apply to all economies trading in goods priced in dollar terms.

However, a generally weaker balance of payments position remains. This could be 'financed' either by foreign loans or reduced surpluses, or adjusted to through changes in the exchange rate or domestic monetary and fiscal policy. Those economies which finance a reduced balance of payments will obviously find it easier to maintain their rate of growth of GNP. Clearly the constraints on being able to do this differ widely within the Pacific Rim economies. Malaysia with a healthy balance of payments surplus, and Thailand with an excellent international credit rating, would find it easier to finance their new balance of payments position than would, say, the Philippines. The decision to finance rather than adjust to a deeper US recession will depend rather crucially on how long the reduction in the US demand for imports is anticipated to last. It will also depend on how other countries react, since the level of reserves needed to finance a reduction in the balance of payments position will be greater if other economies adjust to the US recession.

However, in many of the Pacific Rim economies this decision is secondary to the fact that they have institutionalised an automatic or quasi-automatic adjustment mechanism through the pegging (e.g. S. Korea, Taiwan, the Philippines) or managing (e.g. Malaysia, Singapore) of their currency relative to the US dollar. Thus abandoning the assumption that the US dollar exchange rate is the only currency to adjust, it is clear that those economies whose currencies are pegged to the US dollar will not suffer from the deterioration in the terms of trade due to the initial appreciation of the US dollar. However, their automatic adjustment via the exchange rate will, other things being equal, lead to a further reduction in their balance of payments position since domestic exports are now more expensive. This decline must be rectified if the domestic currency is to maintain its parity with the US dollar. This may occur if liquidity is drained from the economy as a result of the worsening of the balance of payments position.

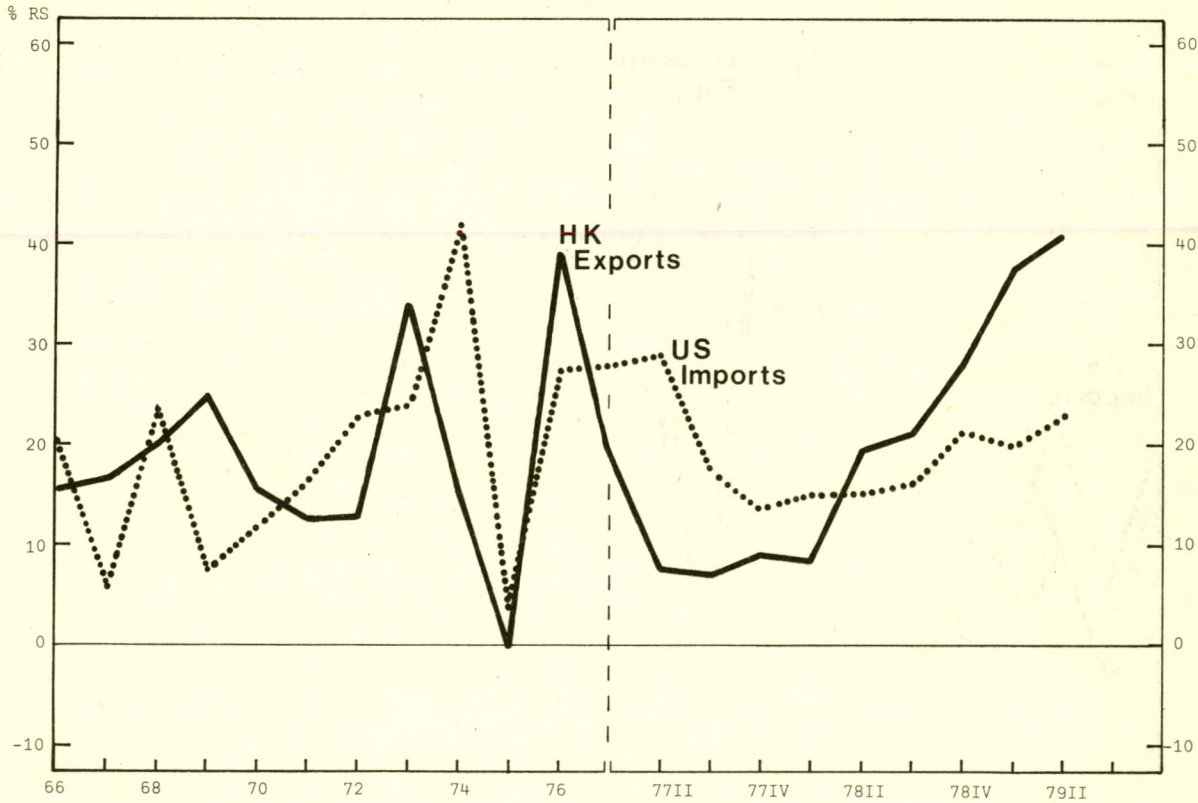
Similarly economies that manage their currencies by pegging them to a basket of their major trading partners' currencies, will overcome the initial unfavourable movement in the terms of trade to the extent of the relative weight of the US dollar in their basket of currencies. Moreover to the degree that a managed currency permits an independent domestic monetary policy, countries such as Singapore and Malaysia could partially insulate themselves from the effects of a US recession by allowing their currencies to depreciate against the dollar. This would be precisely the converse of what has occurred since December 1976, since which time the Singapore dollar has appreciated by 11% against the US dollar thereby insulating Singapore from the full effects of the rise in US inflation.

The interim conclusion is therefore that a deeper US recession leads to a once and for all relative decrease in the real income of those Pacific Rim economies whose exchange rates

are allowed to depreciate against the US dollar. Currencies that are pegged to the US dollar avoid this adverse terms of trade effect but must nevertheless suffer a parallel recession with the US since they cannot operate an independent monetary policy. However, since the terms of trade effect will be relatively small, those economies whose currencies are more closely linked to the US dollar will tend to suffer more from a US recession than those which are not. If we take the two polar cases of a currency which is tightly linked to the US dollar and one whose external value is determined by the growth of domestic money supply then this should be clear. In this first case the appreciation of the domestic currency with the US dollar will tend to lead to net outflows from the domestic monetary base such that a domestic contraction parallels the US one. In the second case the depreciation of the domestic currency against the US dollar is the result of being able to maintain an independent monetary policy, thereby implying some ability to maintain counter-cyclical growth in that domestic economy as compared with the US. On this basis we might expect Singapore, Malaysia and Hong Kong to fare rather better during a US recession than economies such as South Korea, Taiwan and the Philippines.

Economic theory can establish the likely direction of change in economic activity in these economies but it is also important to try and establish the magnitude of these effects. In an economy such as Hong Kong's, which effectively has neither an exchange rate nor a domestic money supply target,

CHART 2 : U.S. IMPORTS vs H.K. EXPORTS



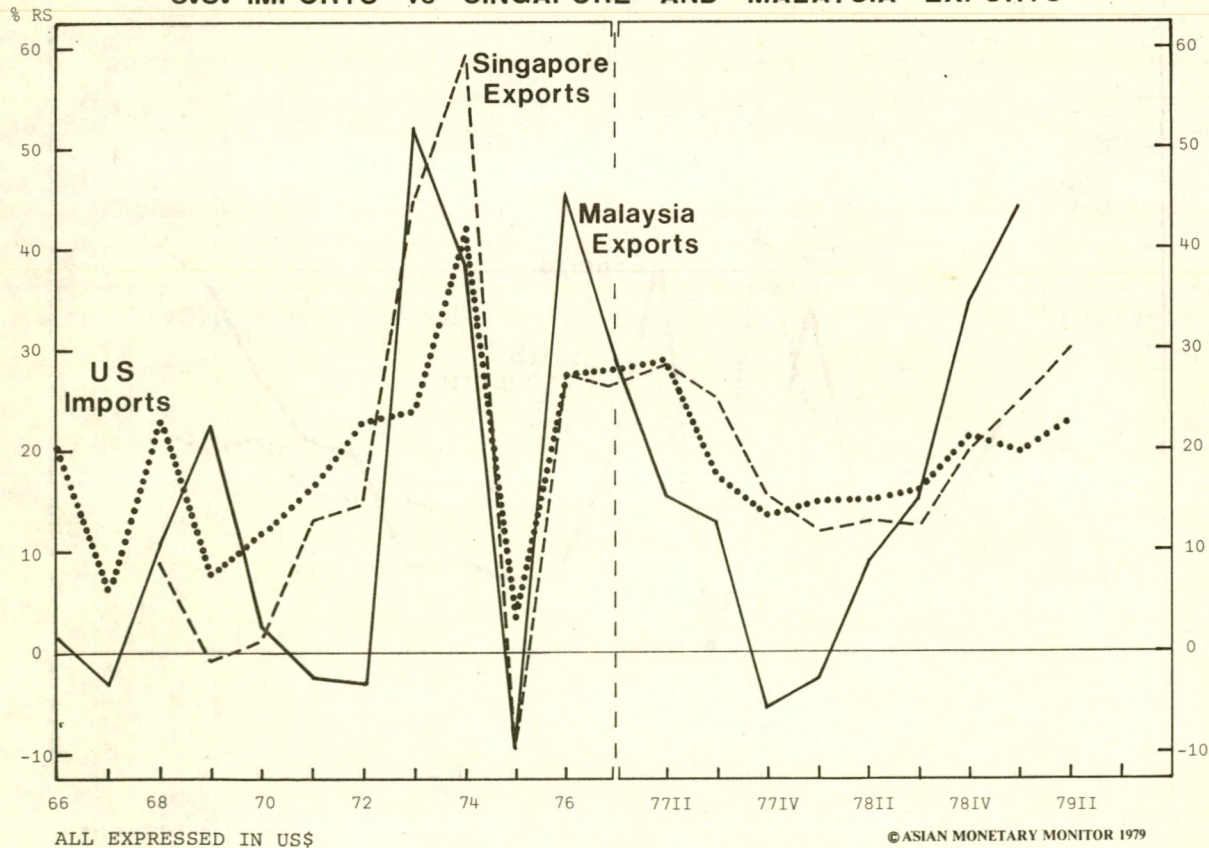
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it is less easy to predict what may happen as a result of a US recession. The conventional wisdom is that, with the US taking up nearly 40% of Hong Kong's exports, the latter must be highly sensitive to the US demand for imports. Although Hong Kong's exports have been accelerating since April 1978 and although this has been associated with an increase in US imports, a brief glance at Chart 2 shows that this relation is not a strong one. The rapid fall in Hong Kong exports growth in 1977 occurred whilst US imports were still rising slightly and in fact this fall preceded the decline in US import demand by six months. Similarly US imports declined later and faster in 1975 than did Hong Kong's exports. The conclusion from this is that US import demand is not necessarily the crucial determinant of Hong Kong's exports that some people imagine. Although Hong Kong is more dependent on US import demand (in terms of proportion of exports by country of destiny) than any other Pacific Rim economy with the exception of Taiwan, its diversity of exports in terms of the composition of goods acts to counterbalance the former factor. Moreover, as suggested earlier, Hong Kong's currency has been allowed to float against the dollar and this insulates the economy, to some extent, against a depression in the US. Of course this insulation of the domestic economy can only be obtained at the cost of a fall in the external value of the Hong Kong dollar and rising inflation, but Hong Kong's nominal growth rate will probably be the least affected in the Asian Pacific as the result of a US recession.

CHART 3

U.S. IMPORTS vs SINGAPORE AND MALAYSIA EXPORTS



This contrasts with the probable effect in Malaysia. Although less heavily dependent on exports as a proportion of GDP, and less dependent on US import demand* than Hong Kong, changes in the value of Malaysia's exports have been more volatile with respect to US imports than have Hong Kong's, as can be seen from Chart 3. An important reason for the high volatility of Malaysia's export trade is its large dependence on the value of exported primary raw materials. (The problem of export revenue volatility arises because raw materials generally have low price elasticities of demand, much higher income elasticities of demand, and very low short term supply price elasticities.) In 1978 primary raw materials accounted for 77% of Malaysia's total exports, and 72% of its exports to the US. Exports of rubber represent no less than 21% of total export earnings. Moreover this dependence on a specific category of product is only being reduced slowly: Manufactures, as a proportion of exports have grown at less than 1% per annum since 1970. As noted in an earlier edition of AMM (Vol. 3 No. 4) floating exchange rates imply that there is no longer any necessary reason for the rest of the world to follow a US recession, and that given the current strength of demand in Japan and W. Germany, raw material prices may remain stronger than they otherwise would have done. These factors imply that the value of Malaysian exports will not fall so rapidly in the coming US recession as they have done previously. However, another important reason for the high variance in Malaysian export earnings is that by linking its currency fairly strongly to the US dollar, Malaysia is unable to insulate itself from the monetary impact of changes in its balance of payments. The decision not to follow an entirely independent monetary policy has accentuated the variance in the value of an already volatile export trade.

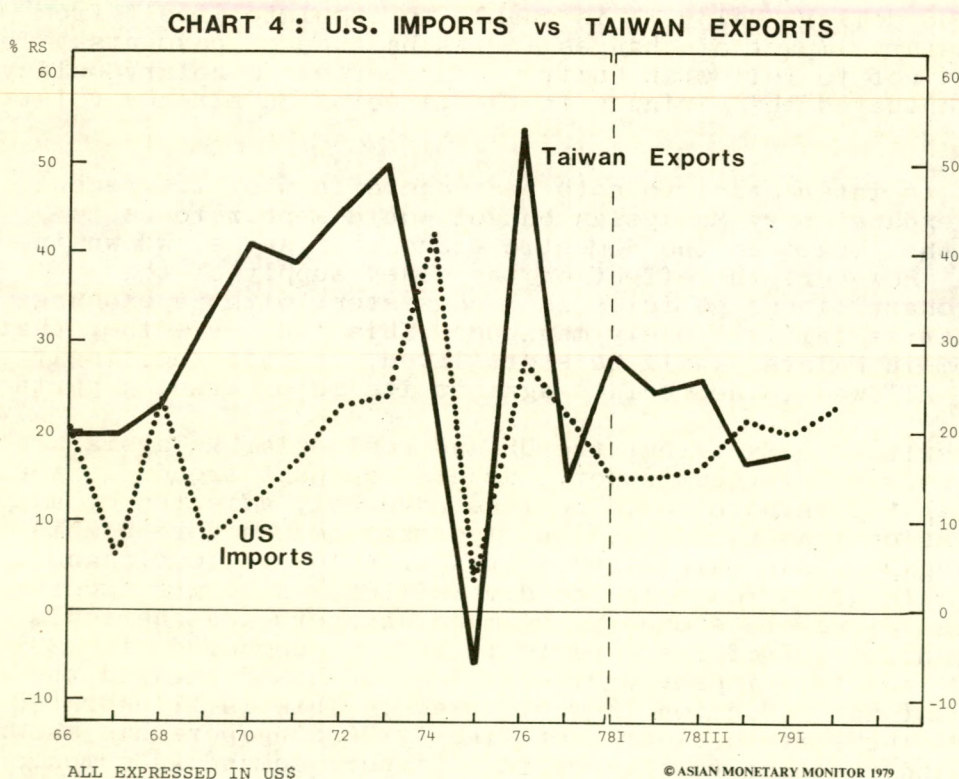
It is interesting to note that one effect of the recent highly expansionary Malaysian budget would appear to be to reduce the impact on the domestic economy of any slowdown in the US. However, the effect on the money supply of these expansionary fiscal policies is inconsistent with an exchange rate that is fairly closely managed. This implies either that any boom in Malaysia will be short lived, or that the ringitt must be allowed to depreciate against its major trading partners.

Despite the fact that the US and Peninsular Malaysia are Singapore's two largest export markets, on past trends it would appear that Singapore could be less adversely affected by a US recession than Malaysia. An important reason for this is that Singapore has maintained a greater absolute level, and higher rate of increase in the diversification of its export products: Singapore's exports of manufacturers and chemicals accounted for 45% of its exports in 1978 as compared with 23% in 1969, and this improved diversification has mitigated the effects of any reduction in world trade. This is illustrated in Chart 3, where it is clear that since 1976 Singapore has shown a dampened response to changes in US import demand as compared

* In 1978, the US was Malaysia's second largest export market, accounting for approximately one fifth of total exports.

with Malaysia. Another factor encouraging steadier growth in Singapore is its growing importance as an entrepot economy. This has reduced its dependence on domestic production. This is particularly true in the case of refined petroleum products, where although Singapore imports some S\$6.25 billion of oil, its net oil related deficit is less than S\$1 billion because of the large exports of refined petroleum. Not only does refined petroleum have a high value added, but this entrepot trade helps to insulate Singapore from the effect of oil and other commodity price changes.

Although the Singapore and Malaysian currencies have maintained a nearly equivalent parity with the US dollar,* the impact of their differing composition of trade implies that they do not enjoy the same degree of domestic monetary independence. The (volatile) surplus that Malaysia has exhibited in both its trade and balance of payments position is prima facie evidence that, as a result of Malaysia's dependence on raw materials exports, the ringitt is somewhat undervalued during periods of expansion in world trade. The increase in the balance of payments surplus in 1979 has been associated with a rapid increase in the rate of growth of the money supply. Therefore, if the Malaysian authorities maintain the close de facto link between the ringitt and the Singapore dollar during any US recession, an initially undervalued ringitt implies a bias towards quantity adjustments through



* Although the official link between the ringgit and Singapore dollar was broken in 1973, in practice the two currencies have maintained very similar parities with the US dollar, and have never diverged by more than 6%.

changes in the balance of payments surplus and the money supply. This is a further reason why we should expect the impact of a US recession to have a greater effect on domestic activity in Malaysia than Singapore.

Turning to Taiwan, it is clear from Chart 4, despite the fact that the US represents 39% of Taiwan's export market and satisfies approximately a quarter of the latter's demand for imports, that US aggregate demand is not a particularly strong direct determinant of Taiwan's exports. Although Taiwan exhibited sustained and accelerating growth in exports up to 1973, her performance since the beginning of 1978 has been historically weak, despite the rising import demand from both the US and Japan which together take up more than 50% of Taiwan's exports. It would appear that Taiwan's 5.26% revaluation against the US dollar is being effective in reducing exports and the trade surplus. At present Taiwan is undergoing a very stringent monetary squeeze: After nearly two years of M_2 growing at a rate in excess of 30%, monetary expansion has been severely curtailed and is currently increasing at around 12½%.* If Taiwan maintains its present parity with the US dollar then an increased recession is inevitable unless the government revises the present trend in monetary growth. However with inflation currently running at 12%, up from 6.2% in January and 7.3% in April (as predicted in AMM Vol. 3 No. 1), this course appears unlikely.

At a fundamental level we may view any forthcoming depression in the US as precipitating a change in relative prices, the first round effect of which is to produce a relative decrease in the real incomes of its trading partners via a worsening in the terms of trade, and to induce a deterioration in their balance of payments. We would expect the US's trading partners to adjust to this. They may do so, basically, either by adjusting their output or by adjusting prices. If they adjust their exchange rate (the price) then these economies may insulate themselves, to a degree, from the effects of a US recession. It has been suggested that Hong Kong and to a lesser extent Singapore may fall into this category. Of course the pay-off for this insulation is a tendency for increased pressure on domestic prices. Where domestic authorities, such as in Singapore, are concerned about domestic inflation, and have the policy instruments to restrict the money supply (cf. Hong Kong), there will be an incentive to maintain the exchange rate and allow output to adjust. Conversely, Taiwan, S. Korea and the Philippines, by maintaining their price, bias their economies towards output changes, i.e. parallel recession. Malaysia, on the other hand, appears to be trying to maintain its exchange rate and increase its output. These aims are inconsistent and one or other of these targets must fail in anything but the short term. If output (and hence employment) adjustment is politically unacceptable then devaluation is the only alternative, as has occurred in the past in the Philippine economy.

* M_1 grew at the slightly higher rate of 14.8% in the year ending in August.

HONG KONG

THE ROLE OF INTEREST RATES IN THE ADJUSTMENT MECHANISM

In a previous issue of the Asian Monetary Monitor (May-June 1979, Vol. 3 No. 3) it was observed that increases in Hong Kong's nominal interest rates appeared to have little impact on either the effective supply of liabilities to the banking system, or on the nominal growth in effective demand for the banks' domestic assets. It was suggested that there are two reasons why large increases in nominal interest rates have failed to secure lasting reductions in nominal bank lending: Firstly, high and rising expected rates of inflation have dramatically reduced the real cost of bank loans and advances. Secondly, and more fundamentally, it was argued that changes in interest rates have no direct effect on the supply of reserve assets to the banking system (see AMM Jan-Feb 1979 p. 7). However, in a statement on 14th September, 1979, the Financial Secretary again referred to the role of interest rates in reducing the growth of bank credit: "The fact that the adjustment process is now no longer working through the depreciation of the exchange rate alone, interest rates having been brought into play as well, has been useful." Nevertheless, it remains uncertain precisely where and how changes in the interest rate structure are to have an effect on the Hong Kong economy, and even more unclear whether any changes that do occur can be regarded as having a stabilising effect.

To have a direct effect on the economy, interest rates must influence one or the other side of the banks' balance sheet. The received wisdom, in Hong Kong at any rate, is that increases in the real interest rate act to reduce the demand for new bank loans by increasing their cost and reducing corporate income. Following this line of argument it is thought that the reduced growth of bank assets will be matched by a correspondingly lower growth of bank deposits. Other things being equal this conventional analysis is obviously true. However, since such a view is only concerned with the demand for bank assets, it is at best only a limited analysis of the impact of a rise in interest rates. Turning to the supply of bank liabilities it is clear that increases in bank deposit rates act to increase the size of the banks' balance sheets as the opportunity cost of holding cash currency rises and the public holds more deposits relative to cash. Similarly, on the assets side, banks will want to reduce to a minimum their holdings of non-earning currency or vault cash through a multiple expansion in lending. In other words, by making cash currency and bank reserves relatively more expensive to hold, increases in interest rates have a tendency to enlarge the amounts of credit banks create for any given quantity of cash currency in the system. Thus the net effect of higher interest rates on the size of bank balance sheets is ambiguous.

This is particularly true of the Hong Kong banking system where the supply of banks' reserves is in any case independent of the level of interest rates. The presumption in the

CHART 1: HONG KONG
DEPOSIT-TO-CURRENCY RATIO

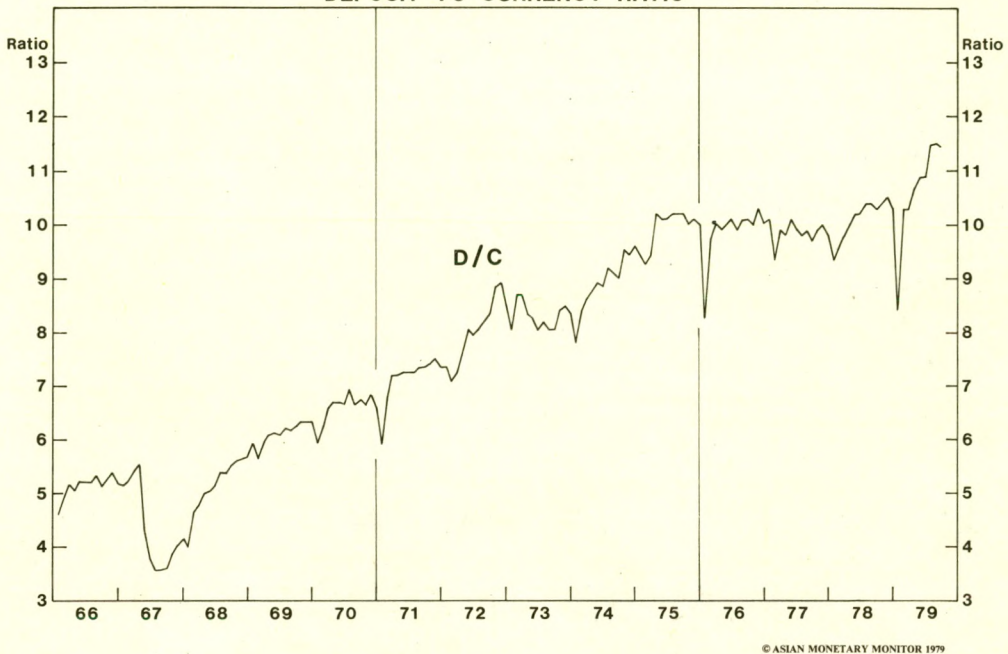
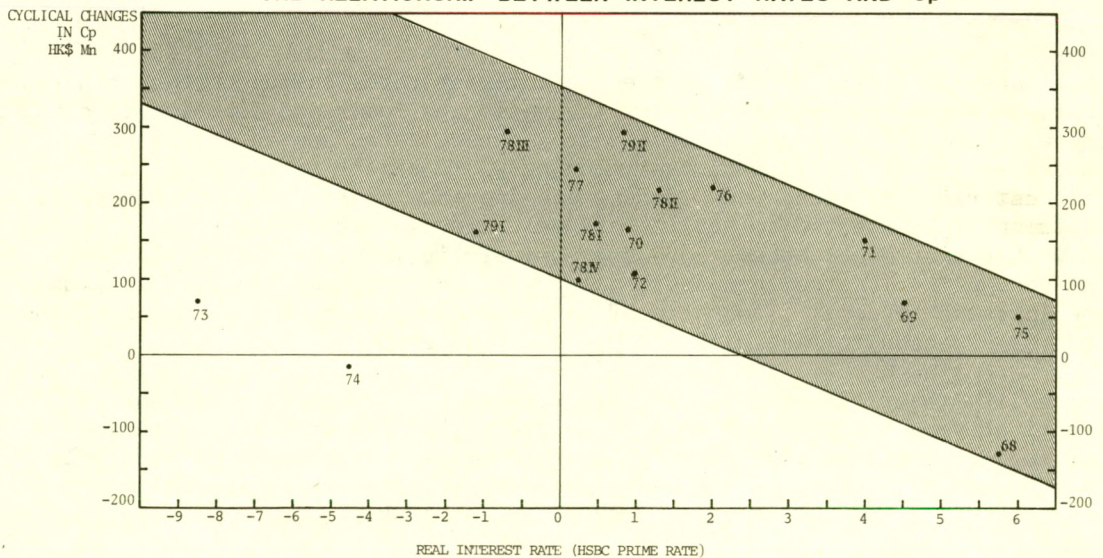


Chart 1

Those who argue that interest rates are an important determinant of aggregate demand must believe that interest rates have a weak impact on the supply of bank liabilities. The secular increase in the non-bank public's deposit to cash currency ratio would appear to support this view, but it should be remembered that this increase is characteristic of all developing economies, and as such support for their argument is reduced. NB: The fall in the ratio in 1967 was due to the withdrawal of deposits during the local riots, and the downward spikes at the beginning of some years result from the timing of Chinese New Year, and the conversion of deposits to currency at those times.

CHART 2: HONG KONG
THE RELATIONSHIP BETWEEN INTEREST RATES AND Cp



Cp : Legal tender coins and notes
in hands of non-bank public

CHART 3: HONG KONG
An Indicator of Bank's Behaviour in Response to Interest Rate Changes

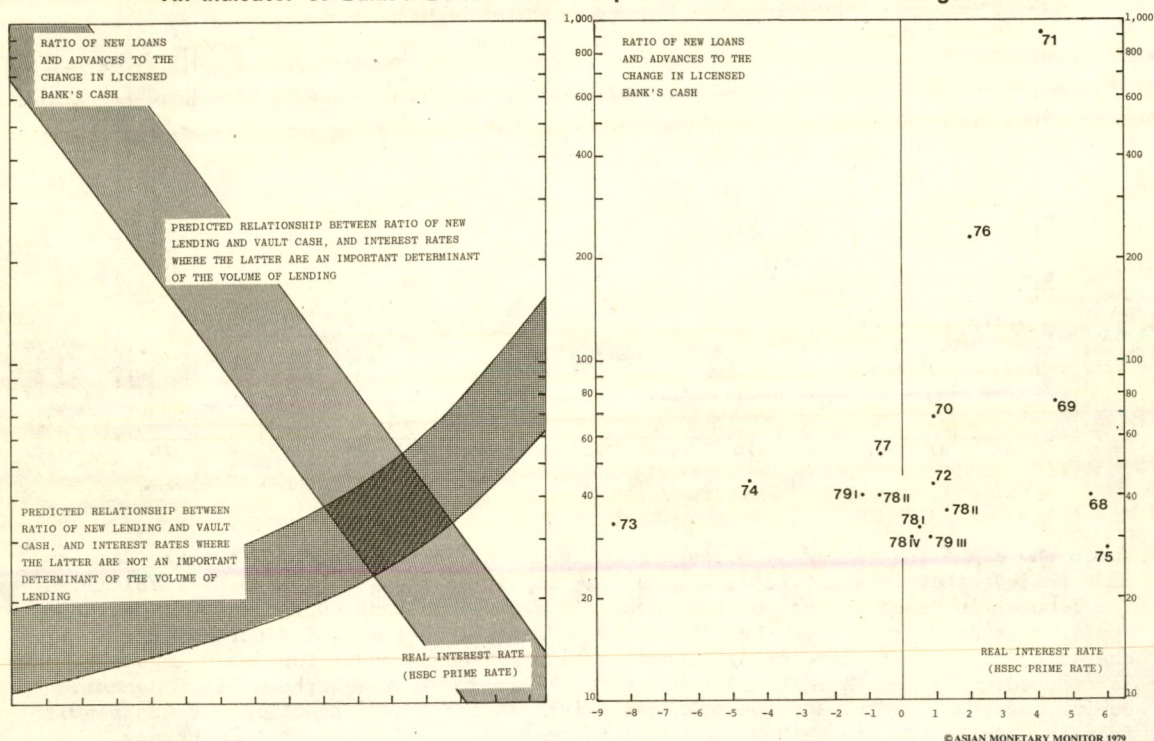


Chart 3:

A suitable indicator of how changes in interest rates influence bank behaviour is to be found in the behaviour of the ratio new loans and deposits to changes in vault cash. Those who believe that interest rates are an important determinant of the volume of bank lending would expect an increase in interest rates to reduce new lending and increase bank's cash. Their ratio would thus be expected to decline as real interest rates rise. The opposing view says that banks behave more aggressively in response to interest rate changes: As real rates increase banks try to economise on their vault cash and increase lending. The ratio of new lending to changes in bank cash would thus be expected to rise with real interest rates.

In reality the ratio follows neither of these possible models of bank behaviour very closely. However it is clear that the available data does not support the view that banks allow their vault cash to adjust passively in response to changes in the real interest rates, as those who believe that interest rates are an important determinant of bank lending would argue.

orthodox analysis is that a reduction in demand for bank assets following a rise in interest rates will be a binding constraint on the size of bank balance sheets and that the public's deposits-to-currency ratio and bank liquidity will have to adjust in line. Effectively this view is saying that the secular increase in the public's deposits-to-cash ratio (see Chart 1) dominates its cyclical trend (which is hypothesised to be a function of interest rates) and that it is only under exceptional circumstances (eg. perhaps, 1967) that changes in the non bank public's portfolio decisions have an impact on bank balance sheets. It also implies that the Hong Kong licensed banks allow their reserve asset ratio to increase with interest rates thus contradicting theoretical predictions.*

In principle all these implications of the orthodox view of the effect of interest rate changes in Hong Kong may be tested. The results are mixed. Looking at the liabilities of the banking system, Chart 2 shows the relation between the level of the non bank public's cash holdings and the level of real interest rates. The data for the non bank public's cash holdings has been detrended to remove the influence of the increase in the demand for cash as a result of real economic growth. The chart shows that the non-bank public decreases its holdings of cash as interest rates increase in real terms, and that with the exception of 1973 and 1974 the relation is quite strong. This observation does not support the view that rising real interest rates reduce aggregate demand in Hong Kong since the reduced cash holdings imply either that the non-bank public has increased its spending, or that it has placed its resources on deposit with the banks where they are then available for lending. Turning to the supply of bank assets a further problem with the conventional view is the way in which banks utilise their reserves in response to interest rate variations. Although the ratio of Loans and Advances to Vault Cash has approximately doubled in Hong Kong over the last decade this is probably due to the increase in the number of foreign incorporated banks who avoid retail banking and can therefore economise on their use of vault cash, rather than due to shifts in interest rates. Chart 3 shows that there is no systematic relation between the ratio of the increments in Loans and Advances to the increment in Vault Cash. Other things being equal one should expect this ratio to fall as interest rates rise if the latter are effective in determining the demand for credit. The fact that this has not generally been the case is prima facie evidence either that changes in interest rates are not an important determinant of the volume of new credit, or that the banks are not fulfilling their duty to their shareholders, in which case interest rate rises are leading to distortions in bank balance sheets.

It is not possible, given the available data, to test the effect interest rates have on the demand for bank credit per se. This is because we lack information on the determinants of

* The reserve asset ratio is the ratio of Specified Liquid Assets (SLAs) to deposit liabilities (net of amounts payable on demand or at short notice to other banks in Hong Kong). The minimum required SLA ratio is 25%, but as a group banks hold SLAs well in excess of this requirement.

individual borrowers' portfolio decisions and it is not really feasible to infer these from the available banking statistics because the data for the real volume of new bank credit only records the net result of changes in the demand and supply of bank assets. Chart 4 appears to indicate that real interest rates are not an important determinant of the total volume of real bank credit. There is a slight indication that the amount of new bank credit is negatively associated with the real interest rate (Total new bank lending has increased three fold since 1975 which corresponds to a secular decline in the real interest rate) but the variance in interest rates has been a weak indicator of cyclical changes in the rate of growth of such credit: Real interest rates have fluctuated between the plus or minus one percent level since 1977, whilst the volume of total bank credit has sustained accelerated growth since July 1978. Similarly, although real rates are now approximately one sixth of their value in 1975, and although this fall has been associated with a nine-fold increase in new lending to the domestic economy, large increases in real interest rates within this period (for example in the first half of 1978) have failed to have a significant impact on the rate of increase in bank credit.

The conclusions one may derive about the effectiveness of an interest rate policy in Hong Kong are rather tenuous but it is legitimate to infer that for interest rates to lead to any sustained reduction in the size of bank balance sheets they must remain at a high real level for a relatively long period. This is because in Hong Kong changes in the interest rate structure have no effect on the supply of reserve assets and are only influential through the (weak) impact they have on the demand for bank assets. If this analysis is correct it implies that an interest rate policy will necessarily lead to a slower reduction in Hong Kong's inflation rate than would a policy aimed at controlling monetary aggregates, since interest rates only have an indirect effect on banks' demand for reserve assets. The effectiveness of interest rate increases would be improved if such rises could be restricted to loan rates. However the likelihood of this occurring is slim since the Exchange Banks Association is unlikely voluntarily to avoid profitable lending opportunities for long. Moreover any non-market regulation of deposit rates merely provides an incentive for the development of non-bank financial institutions who may circumvent any interest rate restrictions imposed by the EBA cartel. Both investors and the EBA should recognize, as the Bank of England has done, that regulating deposit rates and widening margins is only effective in the short term where the EBA monopoly is pervasive. With the growth of Deposit Taking Companies, the rates charged by the EBA cartel will simply determine the proportion of loan demand taken up by the licensed banks.* Ultimately the EBA cartel, since it cannot remain an effective monopoly, will become self-defeating as market share and profits are lost to non-members. The effectiveness of increasing regulated interest rates as an instrument for inflation control will thus be further diminished.

* The current preferential interest scheme indicates that the EBA is aware of this.

CHART 4: HONG KONG **The Relationship Between Licensed Bank Lending** **And Interest Rates**

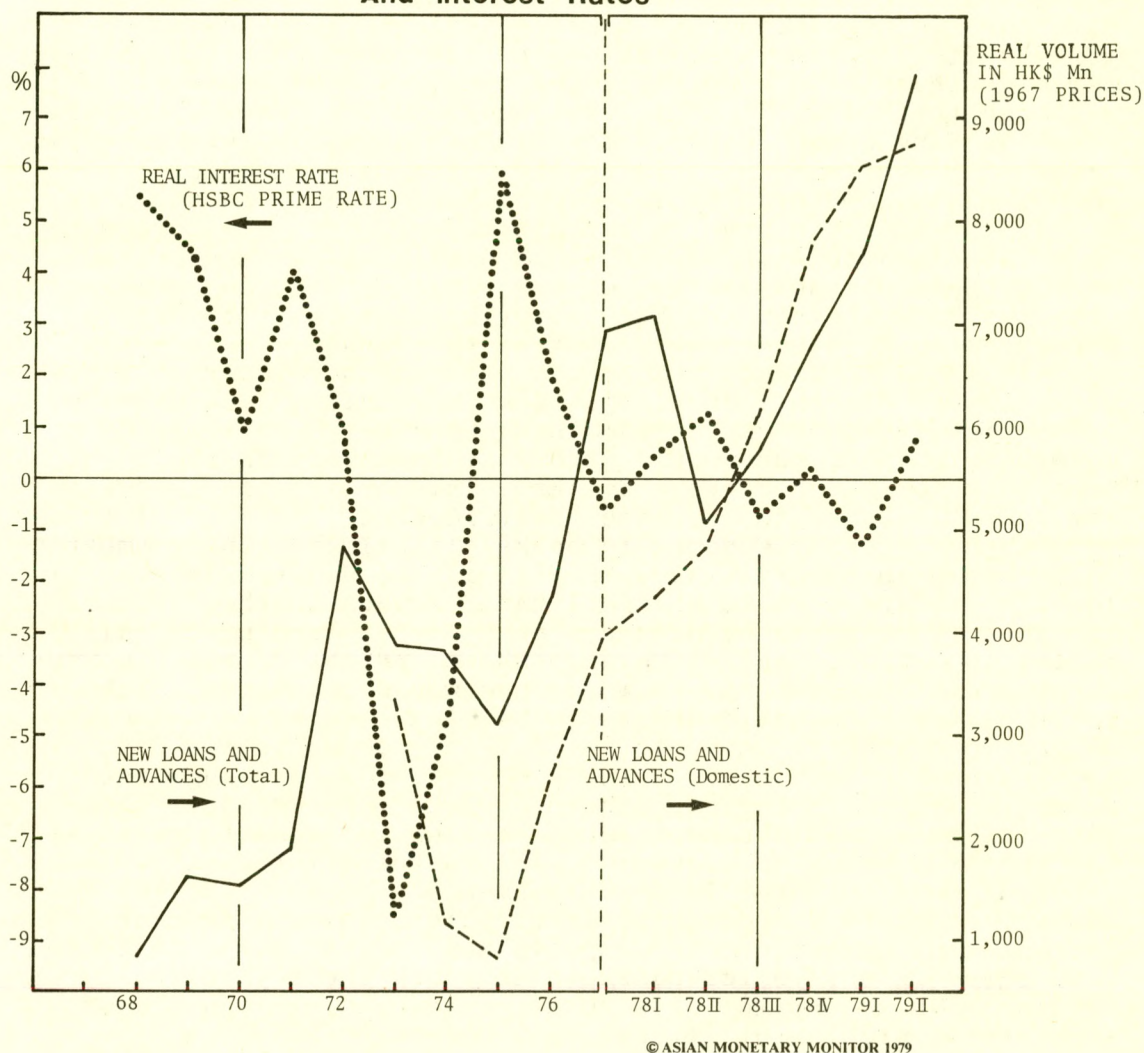


Chart 4:

Those that believe changes in real interest rates are an important determinant of aggregate demand in Hong Kong would naturally expect increases in real rates to lead to a lagged reduction in the volume of new domestic lending. Chart 4 shows that there has been no strong relationship of this kind in Hong Kong.

Obviously, interest rates are not the only determinant of the volume of bank lending, and we should expect changes in expected real rates to influence the decision to borrow. Moreover, companies are not restricted to borrowing in order to finance their investment programmes. They may have plentiful retained earnings from profits and these probably do not vary significantly with changes in the real interest rate. These factors simply underline the difficulty in arguing that interest rates are an effective policy variable in Hong Kong: Even if real interest rate increases were effective in reducing aggregate demand, this would only have a lagged effect on inflation, and in the meantime expected real rates would be falling and the availability of internal financing would be relatively unaffected.

The existence of the banking cartel in Hong Kong is sufficient evidence that changes in interest rates, even if they are relatively ineffective, cannot be viewed as automatic adjustment mechanisms. The licensed banks' interest rate structure is regulated, and broadly inflexible in nominal terms. It will remain so as long as the licensed banks perceive that it is profitable for them. In the meanwhile, although the EBA will explicitly recognise its interdependence with the Hong Kong economy, it will generally regulate interest rates with a view to maximising the joint objectives of its member banks. Observers of the Hong Kong economy should not expect the EBA to behave in any other way. It is therefore by no means clear to what extent the EBA will act to reduce the size of bank balance sheets, or even if they will do so at all. Until we know whether the EBA is trying to operate a money supply, or a foreign exchange target (it cannot consistently operate both) we cannot really evaluate whether interest rates are a potent discretionary adjustment mechanism. For example, if foreign interest rates rise, Hong Kong banks will become more bearish than they would otherwise have been on the prospects for the Hong Kong dollar. This creates an incentive for domestic banks to increase their foreign lending. If there were no change in the domestic banks' liabilities then domestic loans would necessarily have to fall if the desired increase in foreign lending were to be facilitated. Thus in the first instance there would be pressure on domestic lending to fall, whilst the size of banks' balance sheet and the domestic money supply remains constant. However one would not expect banks to contract their domestic assets in this passive manner, and the degree to which they compete for domestic deposits would to some extent reflect their holding to either an exchange rate or domestic liquidity target. Where the EBA pursues an exchange rate target we would expect to see a rise in deposits rates if the EBA is seeking to prevent a fall in the external value of the Hong Kong dollar. This would also enable the licensed banks to compete for domestic liabilities, thereby tending to increase the domestic money supply, and, in the first instance, reduce the incentive for banks to increase their foreign lending. This conflict of interest is a specific example of the general problem of attempting to use the EBA as an instrument for the government's monetary policy. Since the government cannot have complete knowledge of the EBA's objectives, it cannot predict how the banks will react - both with regard to the size, and composition, of their balance sheets - when the inevitable conflict of interest arises. This consideration alone should suggest to investors that the current policy of attempting to influence aggregate demand by manipulating interest rates is fundamentally unsound.

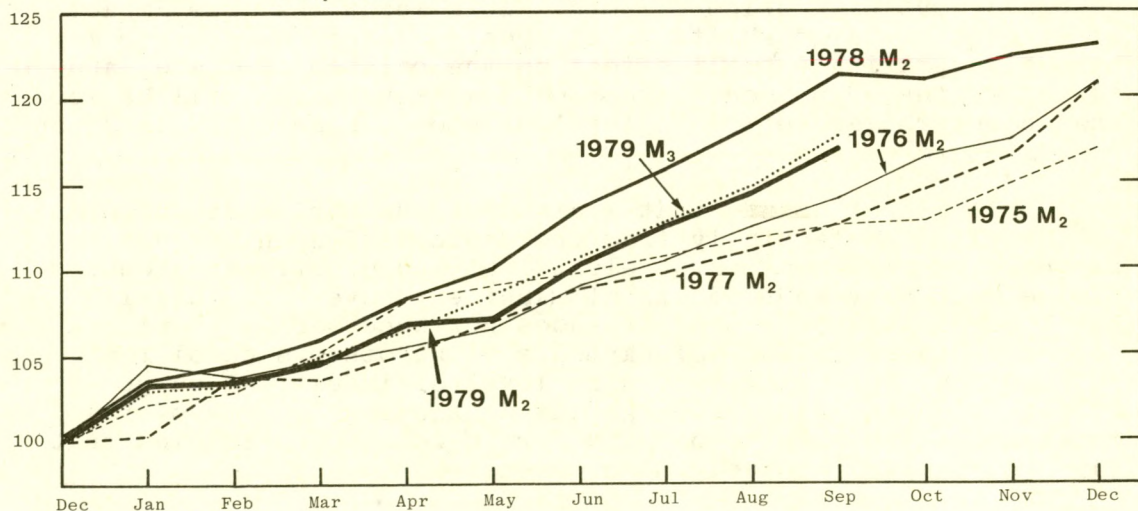
The ineffectiveness of interest rate policy in Hong Kong is due to two factors. Firstly, the real demand for loans is inelastic with respect to the real interest rate, at least in the short term. More generally, control of interest rates - which is becoming more difficult due to the growth of D.T.C.s. - has no direct effect on the monetary base in Hong Kong. Therefore, although it is broadly true to say that if one controls the price of bank loans and liabilities then their

volume will adjust, the EBA, with its own independent objectives, is left with considerable discretion as to the composition of adjustment. Thus although an increase in interest rates would have an immediate impact on market sentiment, the medium term basis for this reaction is harder to discern. Manipulating interest rates in order to influence aggregate demand in Hong Kong is an inefficient and broadly ineffective policy.

Revised Chart

With the release of new data by the Banking Commissioner's office it has become possible to revise our estimates of M_3 in Hong Kong by subtracting D.T.C. claims on banks in Hong Kong from the previous estimates. The new data shows a lower rate of growth than that shown in Chart 6 of AMM Vol. 3 No. 4 (page 12). The annualised growth rate of M_3 in the period Jan.-Sept. 1979 was 24.5% p.a.

HONG KONG
CHART 6
Comparison of Monetary Growth Rates since 1975



M_3 equals M_2 plus deposits of DTC's minus DTC's holdings of cash and DTC's claims on banks in Hong Kong.

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JAPAN

THE YEN AND THE TRADE BALANCE - A MATTER OF VALUE, VOLUME AND PRICE

With the deepening of the current crisis in Iran and the concomitant rise in the price of oil, the Japanese yen has been under a great deal of pressure in the international currency markets. The difficulties Japan faces in procuring a stable supply of oil at a reasonable price and the vulnerability of its economy if oil supplies are cut off are indeed a valid reason for the general bearishness that prevails concerning the prospects for the yen. According to this view two things must happen before the Japanese balance of payments can recover. First it requires a recession in the U.S.A. to bring about an excess supply of oil and a consequent fall in its price, and second it only requires a sufficient depreciation of the yen to make Japanese goods competitive enough to produce a renewed surge of exports leading to a bounce-back in Japan's current account deficit. Unfortunately this optimistic view overlooks two important contributing elements of the current account deficit which will not disappear even if the oil crisis does.

In the first place the overall balance of payments and particularly the current balance must be viewed as a result of the interaction of the business cycles in Japan and the U.S.A. This means that the fortunes of the yen (against the US\$) are at least as much determined by policies decided in Washington as they are by policies decided in Tokyo.

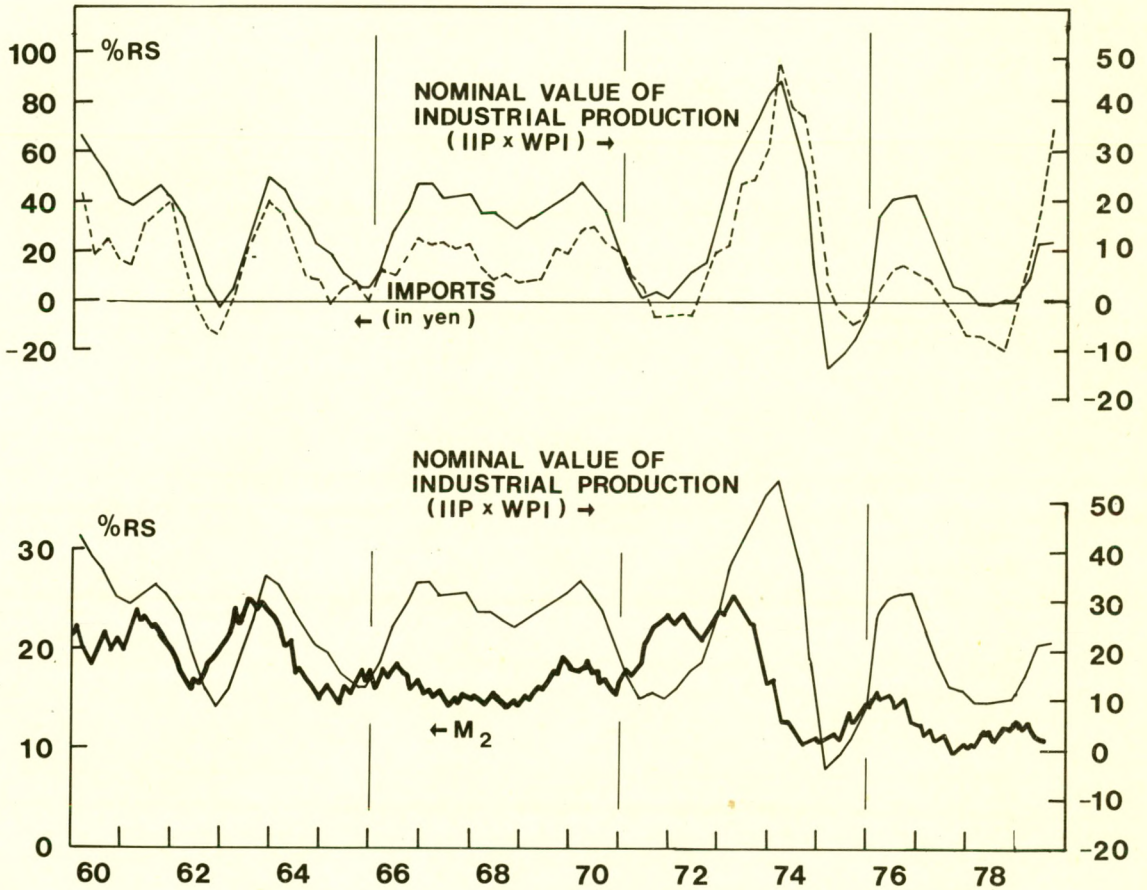
Second, the evidence of recent years suggests that the basic trend of the current balance of payments is much more determined by changes in the relative levels of economic activity than by changes induced through shifts in exchange rates (or relative prices). In other words volume-effects generally outweigh price-effects. This means that the impact of even quite large shifts in the yen/dollar exchange rate may have a surprisingly small effect on the balance of trade, and therefore the adjustment effect of a weakening yen will be more than counterbalanced if the level of economic activity in Japan continues to expand.

This is not to say that individual industries in Japan may not benefit substantially from the depreciation in the yen. Japanese exporters of cars, electrical and electronic products, office machinery and industrial machinery have been thriving. But their continued prosperity does not necessarily signify a strong Japanese balance of payments. The other side of the coin is that the relatively high level of industrial output growth in Japan requires large and continuing imports of raw materials which have to be paid for in foreign currencies that have become progressively more expensive.

It is therefore useful to review the experience of the past decade in order to observe the extent to which fluctuations

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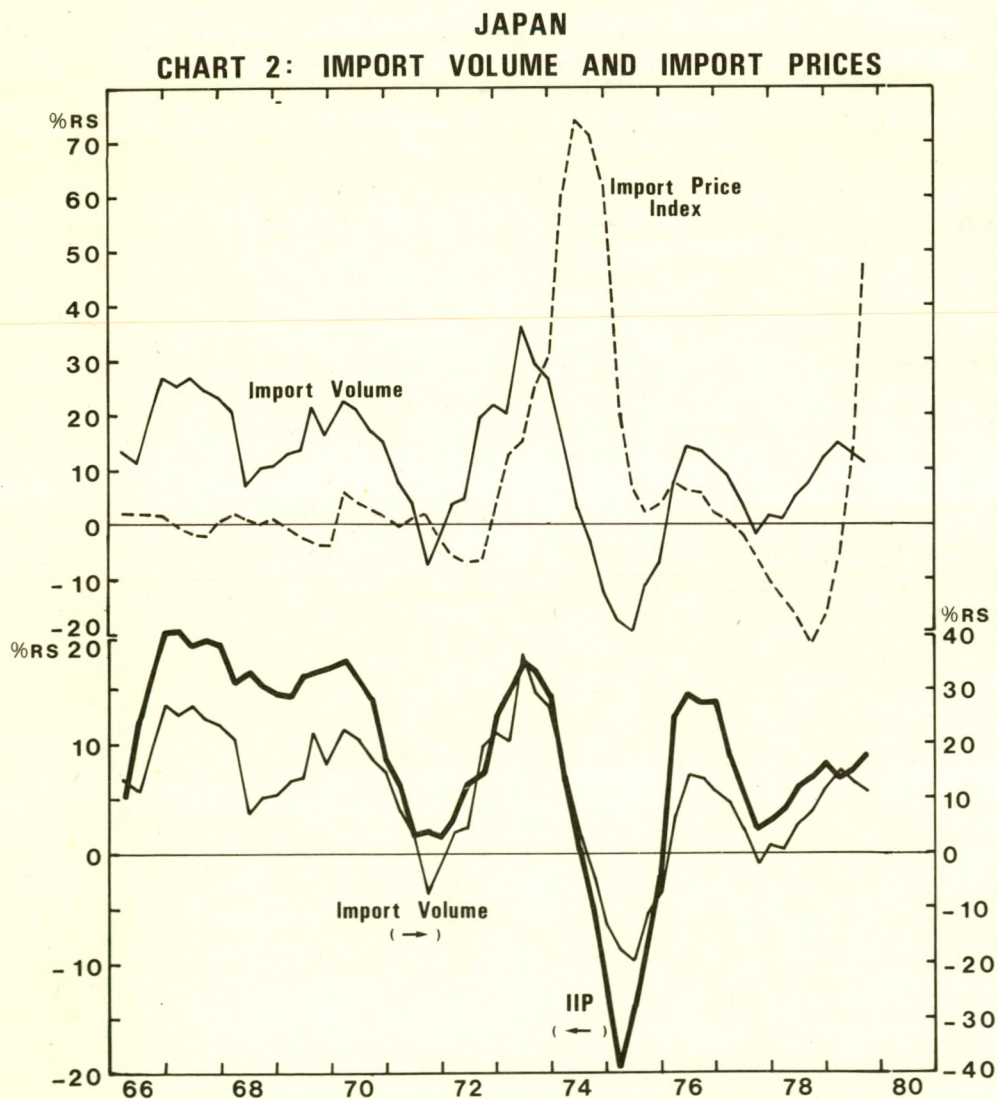
CHART 1 : DETERMINANTS OF IMPORTS



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in Japan's balance of payments have been influenced by the relative level of activity in Japan and the U.S.A. on the one hand (i.e. the volume effects) and by the strength or weakness of the yen (i.e. the price effects) on the other. Chart 1 shows the relationship between the rate of growth of money and the rate of growth of aggregate industrial demand in Japan, as measured by M_2 and a "proxy GNP" (= the product of the index of industrial production and wholesale prices). The close correspondence between fluctuations in the level of industrial demand in nominal terms and the fluctuations of imports over the 15 years covered by the chart is very evident. This relationship between the value of imports and the value of industrial production was explained in a previous issue of AMM (Vol. 2 No. 6, November-December 1978). The closeness of the correlation between the two lines in the upper section of the chart is so striking that it is worthwhile dividing up the value of imports into their underlying volume and price components in order to see which is more significant as the basic determinant of the overall fluctuations in their total value.

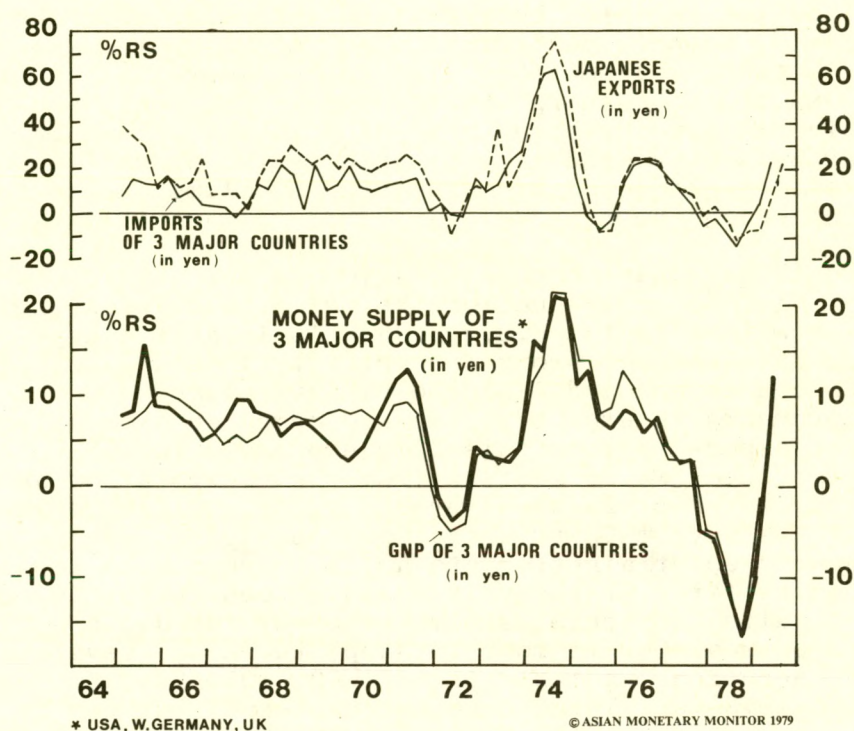
The division between volume changes and price changes is shown in Chart 2. It is immediately apparent that the relation between growth in the volume of industrial production and changes in import volume is extremely close, though as explained in AMM Vol. 2 No. 6 the variations in imports are larger than the variations in industrial production. The remarkable feature of the relationship is that even the huge increase in import prices in 1974 and the big decline in import prices in 1978 did very little to disturb the closeness of the relation between import volume and industrial activity. In other words volume changes would appear to be the deciding factor in determining the general direction of import changes. Conversely, Japanese import demand would appear to be very insensitive to price changes: the 70% increase in import prices in 1974 did not seem to prevent import volume and industrial production from following an almost identical course, while the subsequent 20% decline in import prices in 1978 also seems to have been shrugged off by the simultaneous upward movement of



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CHART 3 : DETERMINANTS OF EXPORTS



both the volume indicators in the lower part of the chart. Thus for imports on both the downswing and the upswing it seems to be the level of Japanese industrial activity which is the overwhelming determinant, almost irrespective of price. In short, as far as imports are concerned, volume wins over price.

The implications of this analysis for Japan's balance of payments position are not at all encouraging. Faced with the current 50% upswing in import prices it might seem desirable that Japan should cut back on its imports in order to conserve foreign exchange. Yet the lesson of recent years is that if industrial production is growing strongly, import volume will follow almost without deviation. And the present situation is that Japan's industrial production is growing by about 10% per annum which in the past has been associated with import growth of the order of 20% per annum. This suggests that unless there is a significant downturn in Japan's real growth rate over the next few months there is no prospect of a reduction in the value of Japan's imports and therefore the country faces a prolonged period - several more quarters - with a substantially higher import bill.

So far as the net trade balance is concerned it is necessary to look at the export side as well because clearly with the depreciation of the yen it may be argued that there might be a significant export boom which could at least compensate for a large part of the increased import bill. Again we will adopt the same procedure as for imports looking first at the determinants of the value of exports, and then at the composition of that value by volume and price.

Chart 3 shows the fluctuations of Japan's exports (in yen) and their relation to the combined expenditure on imports (also in yen terms) of three major trading partners in the upper section, and the relation between total spending and monetary growth (again, both in yen terms) of three major trading partners in the lower section. The recent depreciation of the yen has resulted in a sharp upward move in the money and GNP series which is already being reflected in the upturn in Japan's exports expressed in yen. How is the overall value of Japanese exports affected by movements in volume on the one hand and price on the other?

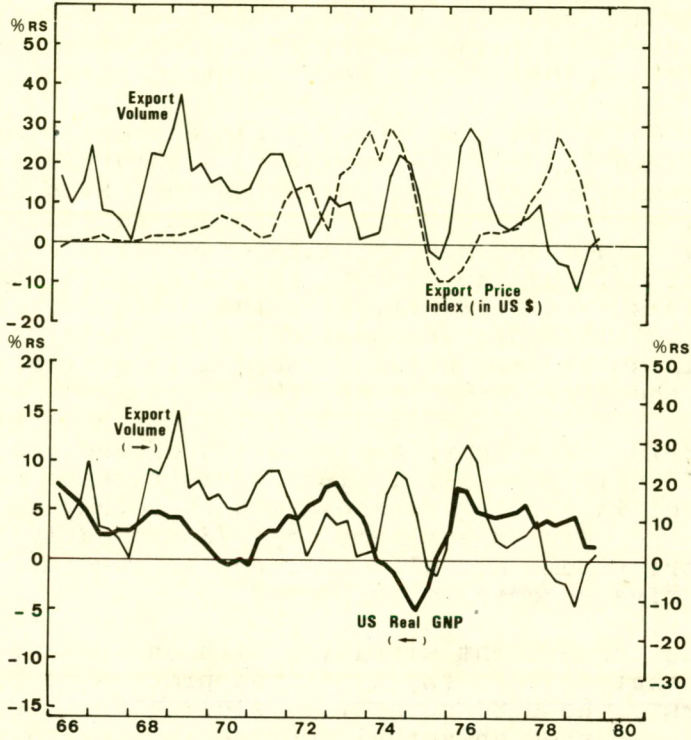
The data relevant to this question is set out in Chart 4 which shows in the lower section the relation between the growth of real GNP in the U.S.A. (Japan's largest single export market and a reasonable proxy for activity levels in other major OECD countries) and Japanese export volume. In the upper section movements in export volume are compared with movements in Japanese export prices, this time expressed in US\$ as this is the price level which matters from the viewpoint of an American purchaser of Japanese products. It will be evident from a quick study of Chart 4 that on the export side things are not nearly so straightforward as they are on the import side. Looking first at the volume indicators in the lower part of Chart 4, although there is some tendency for Japan's export volume and US real GNP to move in step, there are several important exceptions, notably in 1971-72, 1974-75, and more recently in 1978-79. Turning to prices, export prices in dollar terms were fairly flat until 1970-71, then rose steeply between 1971 and mid-1974, declined between mid-1974 and mid-1975, and increased sharply once more between 1977 and mid-1978. As one might expect the main deviations in the behaviour of the two volume indicators (US real GNP and Japanese export volume) are clearly associated with movements in the Yen/US dollar exchange rate.

Chart 5 focuses on these deviations. The chart illustrates the relation between shifts in the yen dollar rate and their impact on changes in export volume. The average quarterly yen/dollar rate has been superimposed on the data shown in the preceding chart (4), and the three main occasions when movements in the yen rate have affected export volume are highlighted by the vertical dashed lines.

- (1) 1971-72. With the yen appreciating sharply in the wake of Mr. Nixon's New Economic Policy measures of August 15, 1971 the yen appreciated from ¥360 to ¥308 at the time of the Smithsonian Conference in December 1971. At the same time the U.S. imposed a temporary 15% surcharge tariff on Japanese imports. Partly due to the psychological impact of the "Nixon Shokku" itself and partly due to the inevitable increase in the price of Japanese goods in the US market, Japan's 20% export volume growth came to an almost complete standstill by mid-1972. As shown by the thick diagonal arrows, the yen's appreciation was reflected in a downturn in export volume growth.

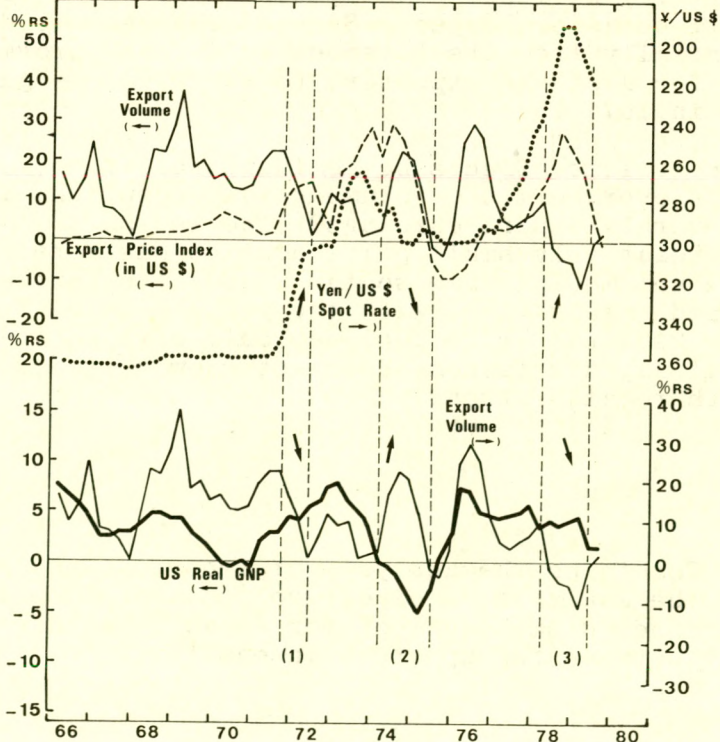
JAPAN

CHART 4: EXPORT VOLUME AND EXPORT PRICES



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CHART 5: JAPAN EXPORT VOLUME, EXPORT PRICES AND ¥/US \$ RATE



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However, the continuation of the boom in the US economy through 1972 and 1973 and the pause in the yen's appreciation in late 1972 enabled Japanese exporters to enjoy a further period of volume growth in 1972-73 before the real downturn came in 1974.

- (2) 1974-75. This time the yen was depreciating and Japanese exporters experienced a remarkable volume increase, despite the US recession. Even so the volume increase was not sufficient to result in an upturn in even the yen value of exports (refer to Chart 3). On the export side, therefore, the volume increase was overwhelmed by the price decrease, with a resulting absolute decline in the dollar value of Japanese exports between the fourth quarter of 1974 and the final quarter of 1975.
- (3) 1978-79. The sharp appreciation of the yen from late 1976 until November 1, 1978 seems to have had some impact in slowing Japanese export volume in 1977, but the main impact came in 1978 and early 1979 when export volume actually declined in absolute terms for five successive quarters.

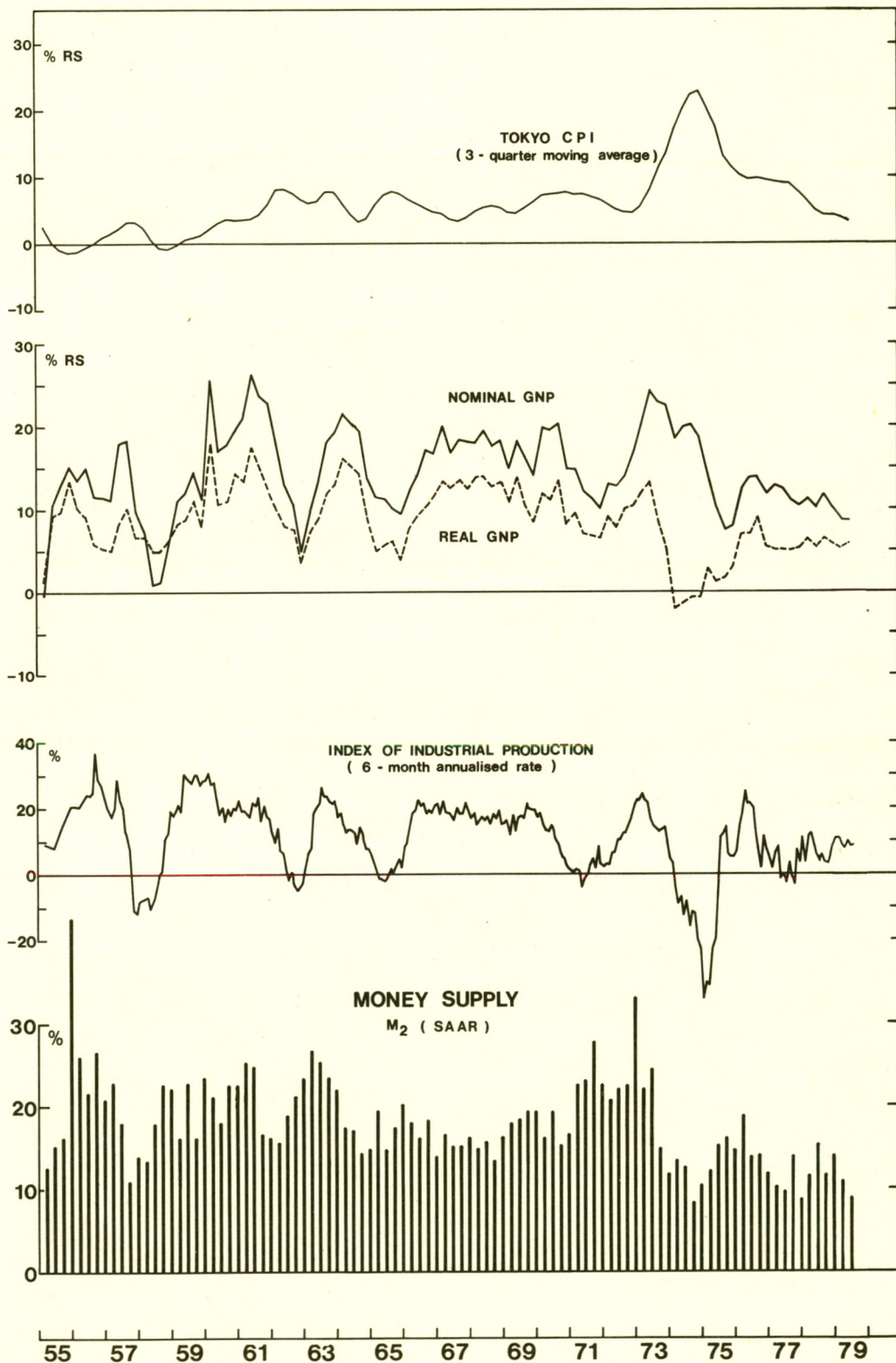
Comparing the present situation with these past events it seems likely that episode (2) is in the process of being re-enacted. First, the U.S. economy is slowing down in real terms and will probably show an actual decline in year-to-year real GNP growth during the first two quarters of 1980, and possibly even beyond that if Mr. Volcker's October 6 measures are resolutely implemented. Thus the decline in the level of US economic activity will not be as steep as it was in 1974, but it could well be as prolonged. Second, the yen has depreciated very substantially from its November 1978 peak, providing the opportunity for Japanese exporters to score volume gains, just as they did in 1974-75.

Will the volume effects be dominant this time, or will the price effects overwhelm the volume gains, resulting in a decline in overall export earnings? The lesson of 1974-75 was that even a relatively small price decline was more powerful than the 20% volume increase so far as total export earnings were concerned. This time, with the yen declining from around 180 to below 240, the price decline could well be sharper - especially if Japan's economy does not slow down and import volume growth remains strong.

FORECAST: Combining the analysis of import volume and price trends with the analysis of export volume and price trends suggests a rather dismal outlook for Japan's balance of trade. The contrast between the apparent insensitivity of imports to

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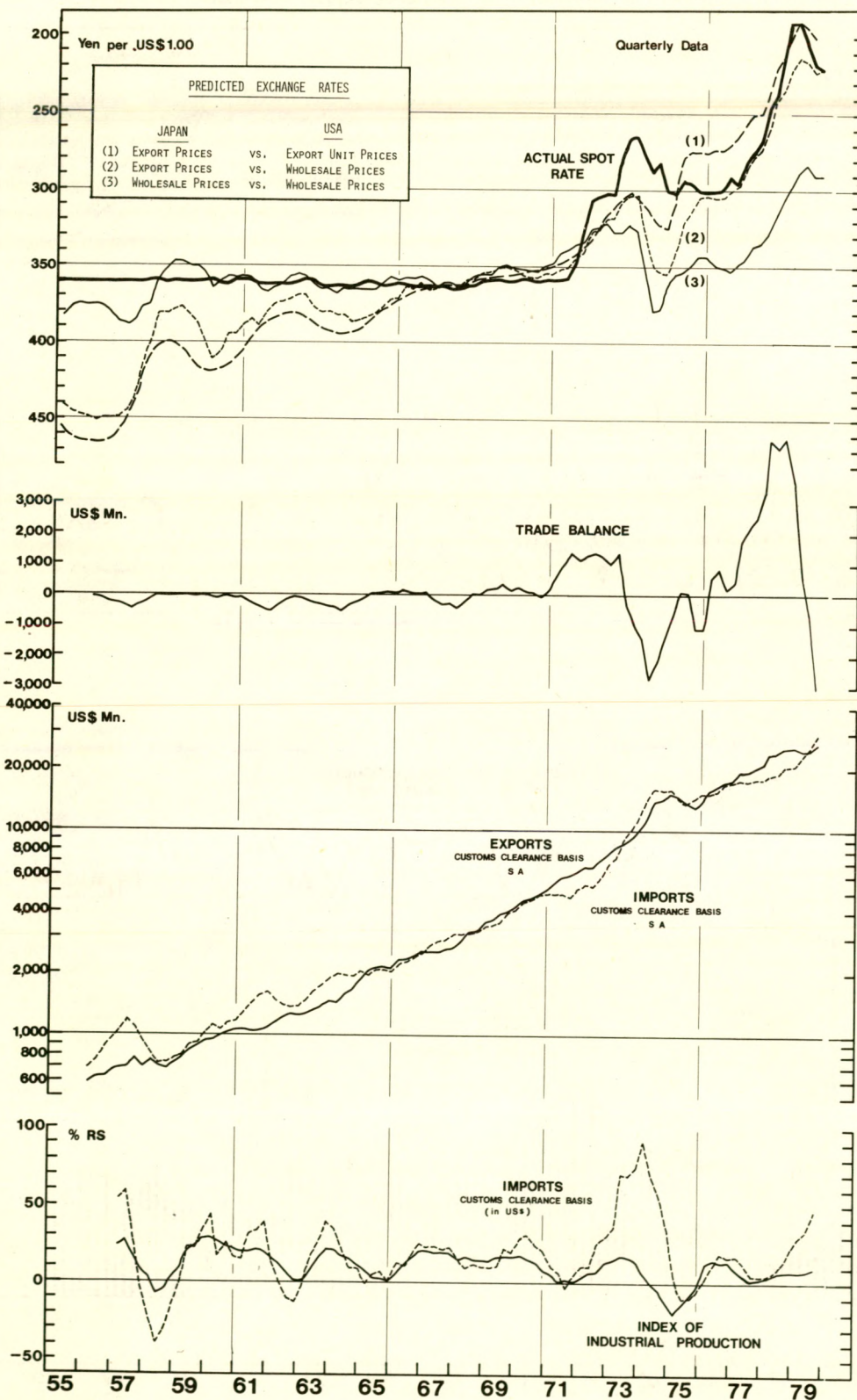
CHART 6 : MONEY, OUTPUT, AND PRICES



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CHART 7 : EXTERNAL TRADE, RELATIVE PRICES AND EXCHANGE RATE



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price changes and the sensitivity of exports to price changes is unsettling. In addition the apparent rigidity of the relation between import volume and industrial production contrasted with the variability of export volume relative to the level of activity overseas is not good news for the yen in the face of an imminent downturn in the US but a continuation of the economic boom in Japan. Unless either (a) the US slowdown is extremely mild and short-lived offering the chance of a pick-up in total Japanese export earnings, or (b) the Japanese economy slows quite quickly in the early months of 1980 leading to a decline in import demand, it would seem likely on this analysis that Japan's balance of payments on current account will continue to be in deficit and the yen will remain vulnerable to further depreciation on the foreign exchange market.

MALAYSIA

OPERATING A MANAGED FLOAT DURING A COMMODITY BOOM

In mid-October the Malaysian budget was presented. To outward appearances it would seem - in the words of one commentator - that "unlike Singapore, which was battenning down the hatches before the world economic storm, Malaysia was presenting a highly expansionary budget aimed at combatting recession, promoting growth and savings, and relieving poverty". This contrasts markedly with the impressive degree of monetary restraint exhibited by the Malaysian authorities since 1976, and, if the description is true, suggests a departure from their hitherto highly successful monetary policies. On the fiscal side it is true to say that deliberately redistributive policies have been enforced in order to reallocate income and wealth in accordance with the ruling UMNO's political preferences. However that may be, on the monetary side the results of their policy have been very striking and the authorities deserve much credit for their achievement in this sphere. Against a background of monetary restraint the rate of increase of the consumer price index remained extremely low from late 1975 until the middle of 1979. (See Chart 1.)

The cornerstone of Malaysia's monetary policy in recent years has been its pegging of the Malaysian currency (the ringitt or M\$) to a basket of foreign currencies weighted according to the relative importance of Malaysia's external trading partners. That policy was first announced and implemented in September 1975. The important press statement released at the time by the Deputy Prime Minister is reproduced in the box on page 30.

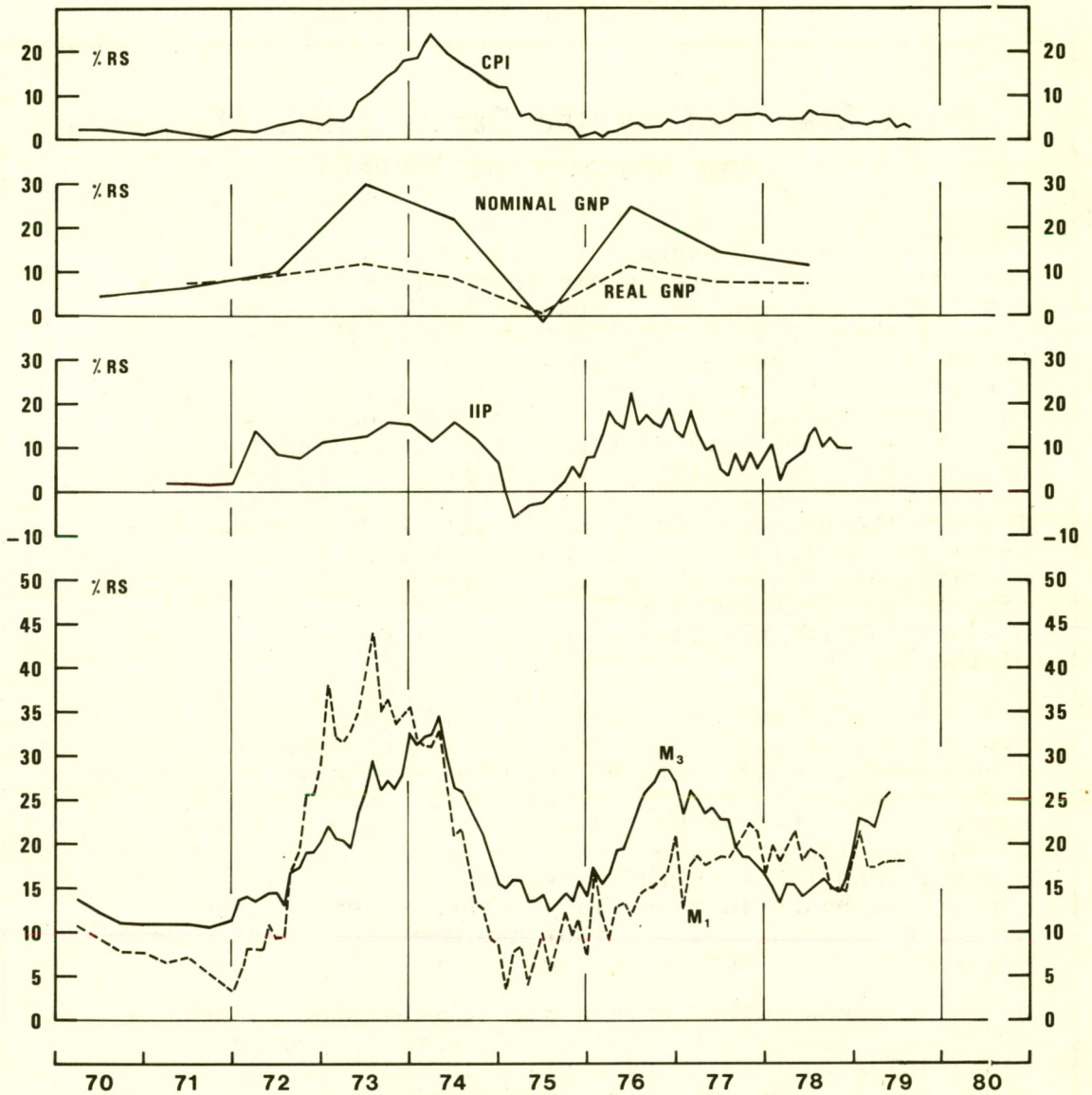
In essence the policy meant that the Malaysian monetary authorities would announce on a daily or weekly basis the external exchange rate at which they were prepared to purchase or sell Malaysian ringitts. It is important to appreciate that having announced the rate at which they were willing to deal, the authorities were willing to supply or purchase any amount of domestic currency, and, because the assets they supplied or withdrew from the domestic money market counted as reserve assets for the banks, there were consequent multiple expansionary or contractionary effects on the banking system as a whole resulting from their purchases or sales of foreign currency.*

During 1977-78 Malaysia's overall balance of payments surplus was modest, permitting a deceleration in the growth of M_3 from 27% in December 1976 to around 15% through most of 1978. However, since the end of 1978 and the early months of 1979 there has been a distinct upturn in monetary growth so that on a year-on-year basis M_3 is now once again showing a

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* NB: This is to be contrasted with the current situation in Hong Kong where purchases or sales of local currency for foreign currency by the Exchange Fund do not imply any such automatic multiple expansionary or contractionary effect.

**CHART 1
MALAYSIA
MONEY, OUTPUT AND PRICES**



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Press Statement by the Deputy Prime Minister and Minister of Finance

1. The rate of exchange of the Malaysian ringgit is determined in the foreign exchange market at present in terms of the US dollar. Because the US dollar has been subjected to substantial fluctuation during the last few years and is itself floating, the rate of exchange of the ringgit has as a result been fluctuating. It has been no longer desirable therefore for Bank Negara Malaysia to determine the rate of exchange of the ringgit in terms of the US dollar alone and to buy or sell the US dollar in order to maintain an exchange rate so determined. Instead the value of the ringgit will be determined in terms of the currencies of those countries which are significant trading partners of Malaysia. It is expected that this arrangement will instil stability in the value of the ringgit in relation to the currencies of the rest of the world.

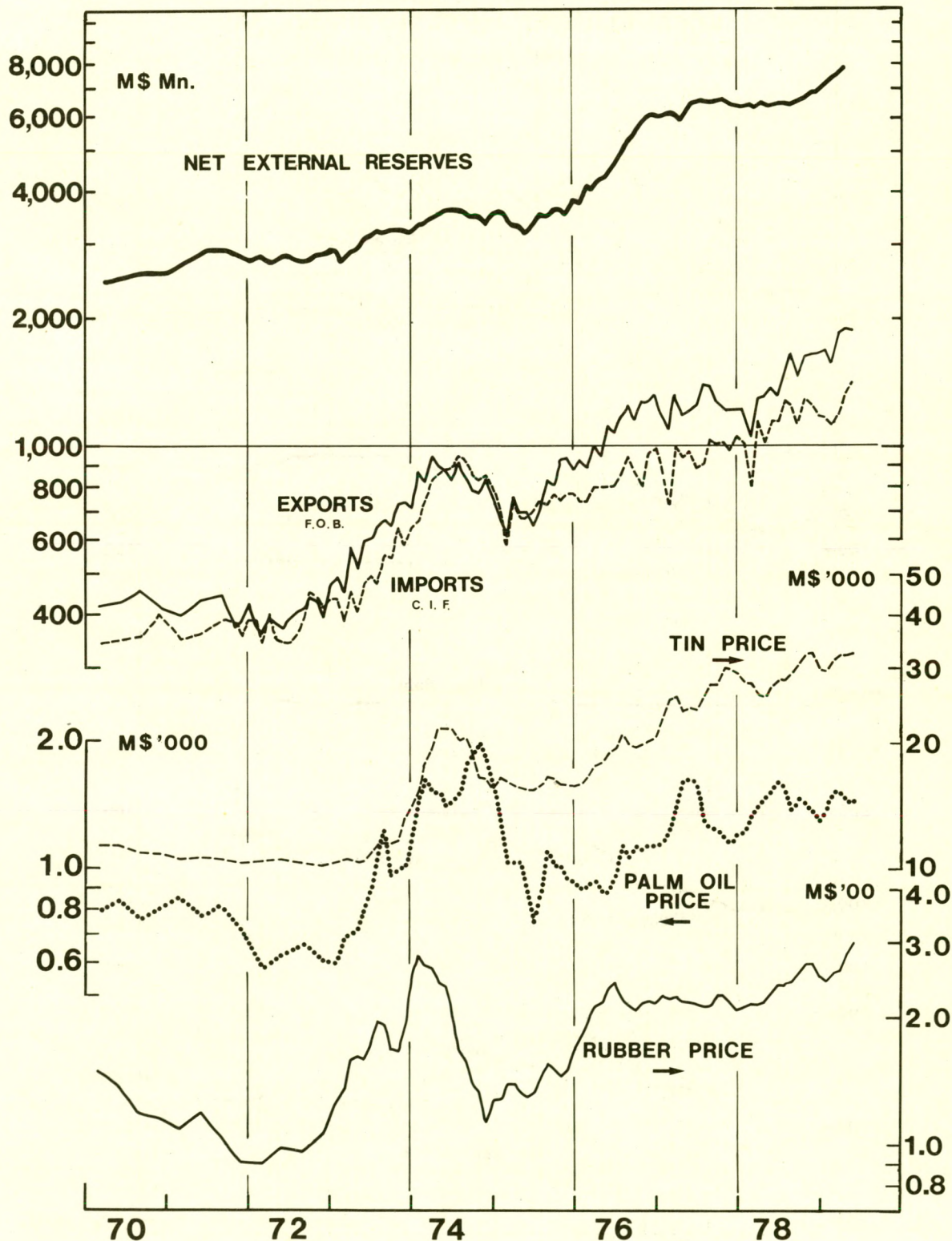
2. This arrangement should not adversely affect the orderly operations of the foreign exchange market. The ringgit will continue to be quoted by the commercial banks for any desired currency in exactly the same way as before. Bank Negara Malaysia will continue to operate in the foreign exchange market in order to maintain orderly conditions in the market and to assist the commercial banks in Malaysia in order to ensure the smooth operation of the market and meet the requirements of traders and other members of the public.

3. The new exchange rate arrangement should serve to strengthen and promote the development of a sound financial structure in Malaysia. In spite of the present recession, the Malaysian economy continues to be basically strong and resilient. Official foreign exchange reserves at the end of August 1975 amounted to \$3.9 billion, about the same level as at the end of 1974 and is sufficient to finance about six months of retained imports at the current level.

September 27, 1975

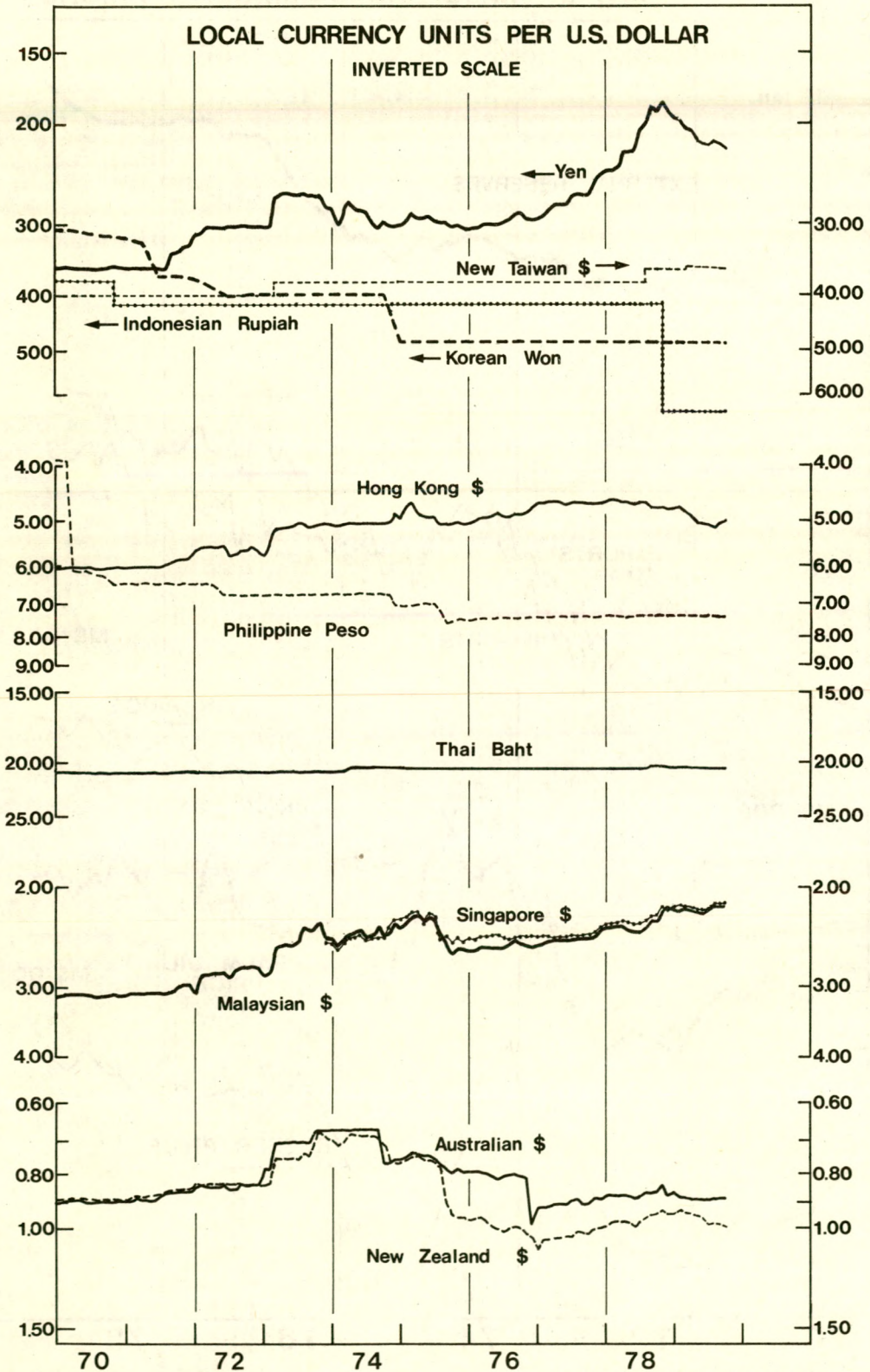
MALAYSIA

CHART 2 : TRADE AND COMMODITY PRICES



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CHART 3 EXCHANGE RATES IN THE FAR EAST



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growth rate of over 25%. The main factor behind this appears to be the sharply improved trade surplus (Chart 2) associated with an increased volume of major export commodities and the improvement in commodity prices. Already in the first four months of 1979 Malaysia's trade surplus was running at almost twice the monthly rate recorded in 1977 and 1978, as prices actually received for rubber (M\$2.46 per kilo), tin (M\$1872 per picul), and palm oil (M\$1351 per tonne), substantially exceeded the prices expected by Treasury forecasters (M\$2.20, M\$1700, and M\$984 respectively).

At the same time, and thanks partly to the continuing monetary restraint during 1978, imports rose fairly slowly from mid-1978 to early 1979, again contrasting with the Treasury forecasts which had predicted a larger increase. As a result the trade balance shifted towards a substantial surplus and, as can be seen in Chart 2, net foreign exchange reserves started climbing in late 1978 suggesting the emergence of a persistent balance of payments surplus.

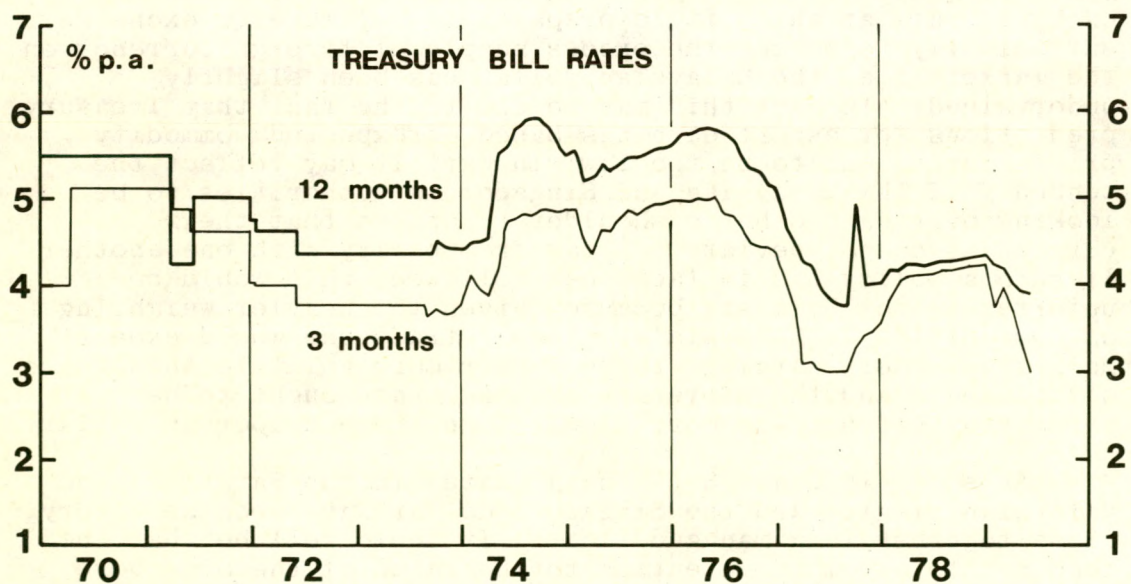
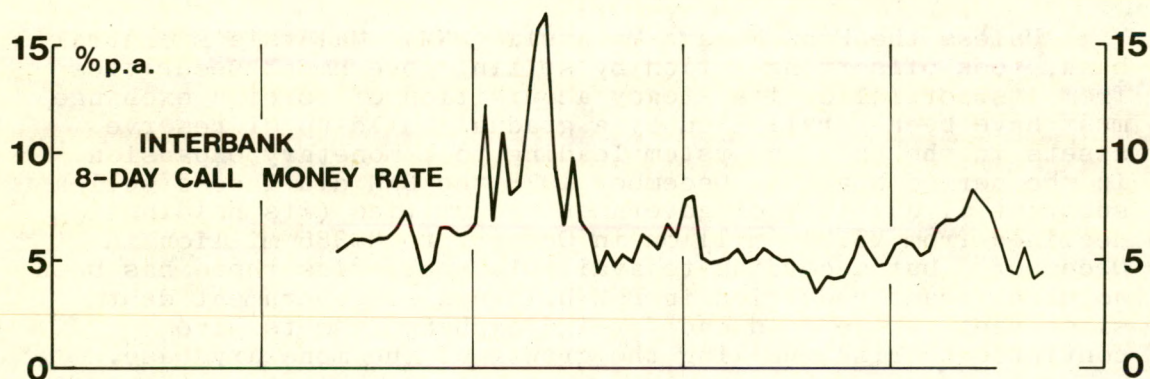
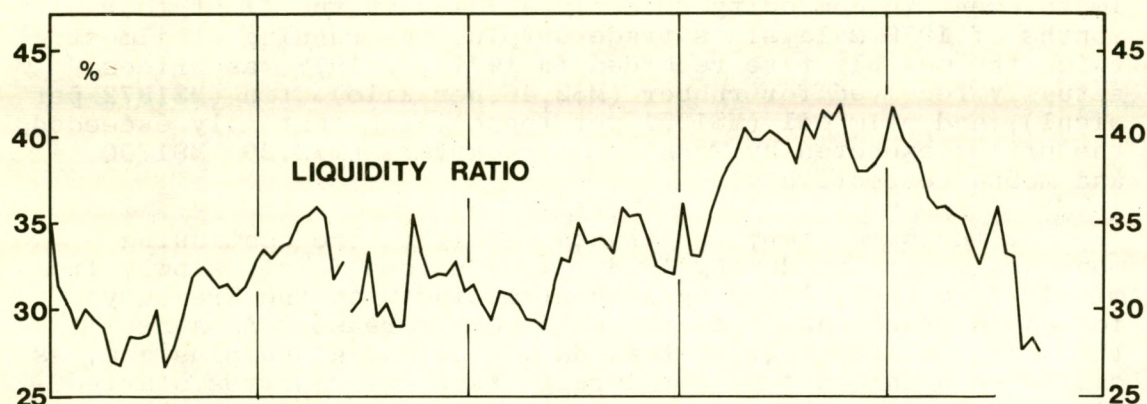
Unless the Bank Negara Malaysia (BNM), Malaysia's central bank, took offsetting action by selling government securities from its portfolio, its steady acquisition of foreign exchange must have been paralleled by a gradual build-up of reserve assets in the banking system leading to a monetary expansion. In the period November-December 1978 the BNM did indeed sell a substantial quantity of government securities (its holdings declined from M\$1240 million in October to M\$385 million in December), but according to available statistics there has been no significant reduction in BNM holdings of government debt since then, while gold and foreign exchange assets have continued to rise fuelling the growth of the monetary base.

The probable explanation for the more rapid rate of monetary growth is therefore that BNM has not moved the exchange rate at which it is prepared to buy foreign exchange sufficiently to offset the excess supply of foreign currency on the market: i.e. the Malaysian dollar has been slightly undervalued. In part this may be due to the fact that Treasury predictions for export earnings based on expected commodity prices turned out to be too low; in part it may reflect the tendency of the Malaysian and Singaporean authorities to be looking over each other's shoulder to ensure that their currencies do not deviate too far from parity with one another. If such a policy has in fact been followed, this would be unfortunate for Malaysia because, given the heavier weighting of commodities in Malaysia's external trade one would expect Malaysian export earnings to be rather more volatile than those of Singapore and therefore its exchange rate ought to be permitted to fluctuate more widely than the Singaporean dollar.

As shown in Chart 3 (Exchange Rates in the Far East) the Malaysian ringitt and the Singapore dollar have been kept very close together in a managed float. It could well be that the tendency to pay more attention to the value of the Singapore dollar than the weighted index which it purportedly follows has been the BNM's undoing.

MALAYSIA

CHART 4 : BANK LIQUIDITY AND INTEREST RATES



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An alternative possible explanation for the more rapid monetary growth which would also be consistent with the available data is that the authorities have been trying to hold down interest rates below natural market levels. Interest rates fell quite rapidly in the first few months of 1979, and subsequently have tended to rise. The decline early in the year was strange, coming at a time when the domestic economy was already growing strongly (see the index of industrial production in Chart 1) and one would normally have expected some firming of rates. However, the accelerated monetary growth appears to have been sufficient to produce falling money market rates and lower Treasury Bill rates (see Chart 4). While the BNM does take a great interest in the level of interest rates, it would appear from discussions with money market participants that there is no overt policy of pegging interest rates on any consistent basis and therefore this explanation for more rapid monetary growth, though plausible, is less satisfactory than the first hypothesis concerning the appropriate level of the trade-weighted index for the currency.

Conclusion: In order to foster domestic stability it is advisable for a commodity-exporting country to allow its exchange rate to vary rather more than the exchange rate of a country such as Singapore which exports primarily manufactured goods. The Malaysian experience of 1977-78 offers a model case-history of how to produce a low inflation rate by means of a managed exchange rate, but it would seem that in 1979 the strength of the country's export earnings caught the authorities somewhat off their guard, and as a result of keeping the M\$ too low in 1979 the inflation rate in 1980 is likely to accelerate somewhat. The error in policy has so far not been a major one, although it will take some months to rectify. However, the task may be simplified by the probable decline in commodity prices in 1980 which will help the Malaysian authorities to operate a slightly tighter policy than they otherwise might have done. It is to be hoped that thereafter the BNM has more success with what has been a fundamentally wise and so far reasonably successful exchange rate policy.

EPISODES FROM ASIAN MONETARY HISTORY

MONEY SUBSTITUTES IN THE JAPANESE COAL-MINING INDUSTRY *

Coal mining in Japan, especially in the Kyushu coalfields dates back to the 15th century, but did not become an important economic activity until the late 18th century. In those days most of the coal was usually extracted just beneath the surface, and shipped to the salt refineries located along the coasts of Japan's Inland Sea. The coming of the foreigners in mid-19th century and the growing demand for coal for steamships boosted the output of coal. The rapid industrialisation of the domestic economy after 1887 was another reason for higher production.

Most of the early mines were small and privately owned by landowners and industrialists. Mining gradually shifted below the ground after 1870. Workers in the pits usually worked in groups of two or more. Sometimes a whole family was engaged in mining and transportation with the father working at the coal-face, and the mother and the elder children collecting the lumps of coal and carrying them in shoulder baskets to the pit's entrance or to a truck.

As the pits grew bigger and the number of workers increased, it became quite difficult for the inexperienced management to handle the amount of hauled coal and the payment of the workers in an orderly fashion. Already in the early 1880s, the mine-owners began to pay workers their daily wages not in cash directly, but partly or sometimes even completely in a kind of substitute paper money (called kippu in colloquial Japanese, which means "ticket"). The reason was that the imperial mint was not able to mint the necessary amount of small coins as occasion demanded, and especially in rural areas a lack of coins in smaller denominations was often reported.

Two different kinds of paper money substitutes developed: the first was a piece of paper on which the amount of coal was written. Such notes were given to the workers each time they delivered a full truckload at the pit's entrance. These paper notes were called kin-ken (kin ... a weight unit, 1 kin = 1.32 lb.), tan-ken (coal-coupon), or yama-satsu ("mine"-paper money). Today we call money substitutes of this group saitan-kin, which means "mining money certificate".

The second kind of money substitute was a paper note which specified not the amount of coal delivered, but a certain amount of money. This group is called kobai-kin, which means "purchasing money certificate".

Both kinds of certificates can be divided into two groups: certificates which could be converted into cash and certificates which could only be used for exchange into goods. These

* The article was contributed by Dr. Erich Pauer, Japanologisches Seminar, Universität Bonn.

FIGURE 1

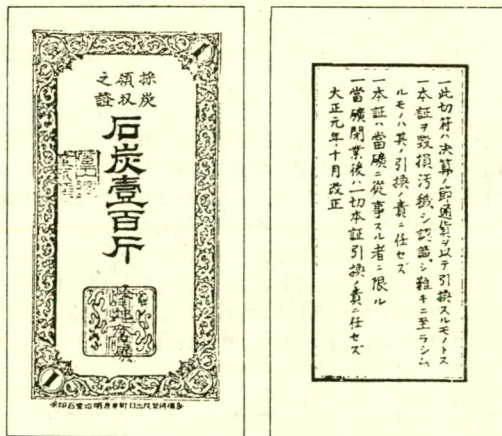


Fig. 1 : Coal mining certificates (Type A 1) with vertical lettering equivalent to a coal amount of 100 kin (132 lb.) and worth 10 Sen. Fig. 1 shows two different mine-owner's stamps; Mineji-mine (left) and North Kyushu.

The regulations on the back read as follows:

- This certificate can be exchanged into cash at certain times
- No responsibility for the exchange is assumed in case of a damaged, contaminated or not clearly identifiable certificate
- The use of this certificate is limited to persons employed in this mine
- This certificate will not be exchanged after the closing of this mine.

October 1913, revised.

(The certificates are printed by the courtesy of Inatomi Kiyoshi, Chikushino-shi, Fukuoka prefecture, Japan)

different kinds of certificates can be listed in the following way:

A) Coal mining money certificates

A 1 for exchange into cash

A 2 for exchange into goods

B) Purchasing money certificates

B 1 for exchange into cash

B 2 for exchange into goods.

This classification also represents the historical order of use, beginning with the certificates of the A1 type, being followed by A2, later by B1, and then by the B2 type.

The coal mining money certificates (saitan-kinken) were gradually replaced by the purchasing money certificates (kobai kinken), the latter being almost exclusively used for paying wages by the 1920s.

The earliest coal mining money certificates date back to the year Meiji 20 (1887). The certificates vary in size (from the smallest one, 6 x 3 cm, to the largest ones, 16 x 9 cm) and style. Usually the certificates were printed in local printing shops, in the earlier years the greater part of them in Hakata or Fukuoka, and later also in other places, like Osaka etc.

A quite complicated design was used to guard against counterfeiting and colours were also used with the same intention. Another difference is seen in the vertical printing of the lettering (used in the earlier days), or horizontal lettering (which became popular after 1900).

On the front we usually find the name of the certificates, the name of the coal mine, and the amount of coal equivalent. Sometimes the certificates were numbered, in case a mine owner wanted to check the amount of certificates in circulation. Rare examples of the certificates show pictures of the mines printed on the front. The authenticity of the certificate was proved by the (red) seal of the mine owner. For examples of such certificates with detailed translations see Figures 1 and 2.

FIGURE 2

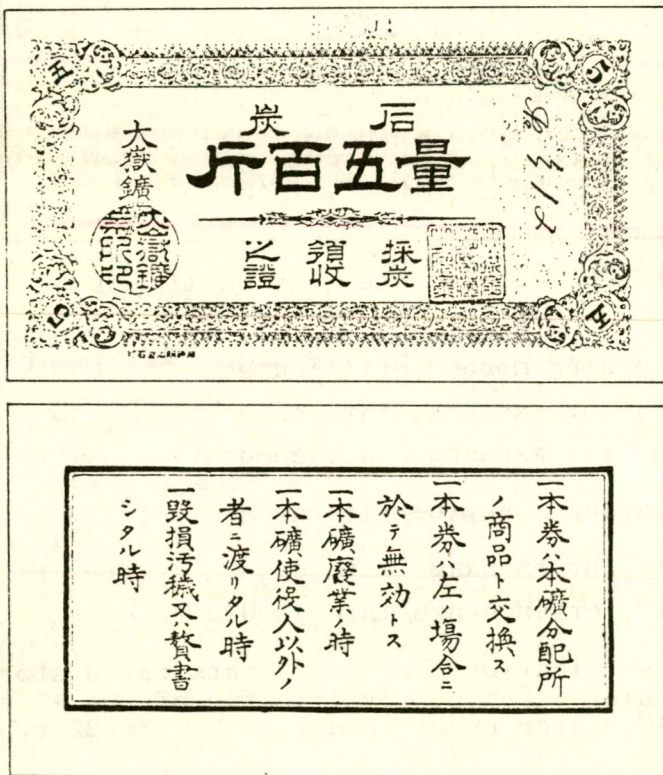


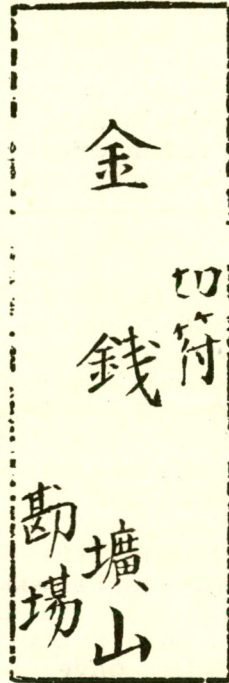
Fig. 2 : Coal mining certificate (Type A 2) with horizontal lettering equivalent to a coal amount of 500 kin (660 lb.) and worth 50 Sen; Otake-mine, North-Kyushu; serial number on the front right-side, the mine-owner's seal on the left.

The regulations on the back read as follows:

- This certificate can be exchanged into goods in the mine's own distribution shop
- This certificate becomes invalid in case of:
 - * the mine being closed
 - * being handed over to persons not employed in this mine
 - * being damaged, contaminated and falsified.

FIGURE 3

Fig. 3 : Purchasing money certificate (usable for different mines and different amounts of money) with vertical lettering. Mine owners used to put certain figures in the lower part. (Stamp print by the courtesy of Mrs. Hosokawa Akira, Library of Taku, Taku-shi, Saga prefecture, Japan)



The denominations of the certificates ranged from 1 to 5000 kin (1 kin = 1.32 lb.), but according to the mining conditions a daily output between 600 and 900 kin (792 - 1188 lb.) was the average, and therefore certificates of smaller units as for example those between 10 and 200 kin were mainly used. Only in the later years, around the First World War and afterwards, when mechanization also boosted the daily output, were certificates of higher denomination used.

On the back of the certificates we find detailed regulations concerning the use, validity and exchange of the notes (see Fig. 1 and 2). Sometimes the exchange rate (1000 kin = 1 Yen, or 10 kin = 1 Sen) was specified on the certificate. But since on certificates printed between 1890 and 1920 this rate remained unchanged (in spite of inflation etc.), it is believed that only the amount of coal was counted for the exchange in practice.

A rare example of a purchasing money certificate (Fig. 3) comes from the town Taku in Saga-prefecture. There a coal mine owner printed his own money himself. He used a stamp (Size 53 x 136 mm) on which the characters for the amount of money (kane Sen) are engraved in the middle. On the right of the stamp are engraved the characters for kippu (which means "ticket" or "certificate"), and in the lower part, the name of the mine. Between the characters kane and Sen, there was a small hole in the stamp, into which the numerical characters could be fitted, and the printer for self-made money was ready for use. The period during which this stamp was used and the amount printed is unknown.

In 1897 nearly 400 different kinds of certificates are said to have been used by 66 mines in Northern-Kyushu, but only 160 different kinds of certificates are known today. These come not only from Northern-Kyushu, but from all parts of Japan where such money substitutes had been used.

The use of coal mining certificates is often connected with a special working organization called "naya-seido", where the miners lived together in long houses and worked under a foreman, who acted as a sub-contractor between the mine-owner and the miners.

In such a system the sub-contractor concluded the contracts for his workers and received their wages in a lump sum from the mine-owner, which he distributed among them. Often sub-contractors held their employees at their mercy and withheld part of the wages. The introduction of the certificate-system is therefore often seen as a means by which the workers could check the amount of coal mined by each of them and thus secure an adequate payment from their bosses.

On the other hand, this system also had many disadvantages. The exchange of the certificates into cash only occurred once or twice a month on certain days. Miners who were in urgent need of cash and could not wait for the exchange day had to rely on dealers, who converted their certificates against a high commission. In addition the regular conversion of the certificates into cash was in some mines subject to a 10 to 20% fee. Because of the unfavourable exchange rate the certificates were worth only part of the amount printed on them. In this way the workers were defrauded of a certain amount of their wages. Worse than that was the fact that according to the regulations printed on the back of the certificates, they lost their validity when the mine closed or went bankrupt. So workers without cash deposits were often faced with ruin in the case of a closedown, which - especially in the smaller mines - happened very often.

In the early days the amount of money which was equivalent to the amount of hauled coal was printed on the certificate, but later the exchange rate was determined by the mine-owner or the sub-contractor according to the actual situation of the mine. Moreover, in many mines the practice of converting the certificates into cash gradually ceased and it became common for the certificates to be used to buy goods in special shops located within the mine area, and run by the mine-owner or one of the sub-contractors. Certificates issued by bigger mines, for instance those of the Sumitomo-, Mitsui- or Mitsubishi-mines, were accepted by shops outside the mines and in a wider area than those of small, unknown mines. Due to this development the simply printed certificates became a kind of paper money, valid within a limited area. In extreme cases this led to a situation where the miners did not receive any cash at all and only shop-keepers and money-changers appeared at the mine's exchange office. As for the miners, this process implied a worsening of their working and living conditions. Firstly it became a hindrance to their freedom of movement, because the certificates' area of validity was limited. Wages paid in

certificates could neither be used freely nor transferred to other places in Japan. Secondly, by the use of the certificates, the workers were forced to buy in the mine's shop or at shops in the nearby villages where certificates were only accepted at a substantial discount. Sometimes the buyers using the certificates had to pay higher prices than those paying in cash.

From the historical point of view money certificates from Japanese coal mines have to be seen in the context of the transition from payment in kind to payment in cash. The lack of small coins was a hindrance for the use and circulation of cash, so that wages had to be paid in the traditional way, in kind. Later the money certificates became a locally valid money substitute. Because of the remote location of the coal mines, the money certificates were still in use in times when other areas had already adapted to a modern money economy. Due to the shortage of small-denomination coins the use of money certificates was prolonged until the printing of new certificates ceased in Taisho 8 (1919). However most of the mines continued to use their existing stock of certificates as money substitutes until well into the 1920s.

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BOOK REVIEW

"The Fiscal System of Hong Kong" by H.C.Y. Ho
Croom Helm, London 1979.

Since 1945 the Hong Kong economic structure has undergone a dramatic transformation which has both reflected, and contributed to, sustained high rates of growth. Ho's study attempts to examine the impact of the fiscal system on a developing economy that is unusual for its remarkable increases in real incomes and very small agricultural base. The author presents a detailed investigation of the evolution of fiscal policy during this transitional stage. He proceeds to assess its relation with economic development, economic stability, and the distribution of income, and tries to ascribe a direction of causality between these important aspects of a developing economy. He also compares the effects of the Hong Kong's fiscal policy with that of the fiscal policy of other developing nations in South East Asia and finds that some facets of the Hong Kong system should be used as a blue print for their economic growth.

This prescription is at best of limited value, and is likely to be misleading. Hong Kong's development, though impressive, is atypical, and not simply because it has been successful. Ho admits that the presence of entrepreneurial expertise, capital, and Hong Kong's historical position as an entrepot makes it exceptional with regard to other developing economies. It is, however, Hong Kong's limited agricultural base which has made it unique as a less developed region. Other countries face the constraint of slow increases in agricultural productivity and value added, and this is likely to remain the case irrespective of which fiscal system is adopted. Moreover, even according to Ho's own estimates, the fiscal system's contribution to growth has been small with "other factors" accounting for 7/8ths of Hong Kong's growth. Its only important contribution has apparently been through the external economies created by the provision of a capital infrastructure. Although government capital formation undoubtedly does encourage growth in the early stages of development, the 11.1% of post war growth that Ho attributes to government investment is open to doubt. To the extent that government investment is a substitute for private capital formation we would expect a corresponding reduction in private saving. Ho chooses to ignore this. Moreover, there can be no presumption that the government is investing efficiently. Other things being equal, public capital formation is efficient if, and only if, the real risk adjusted return to the marginal public project is equal to that available in the private sector. Ho may argue that other things are not equal and that the government has differing objectives to the private sector. If this is the case then it is a position which needs defending. In any case, Ho should not avoid its discussion.

Although the net effect of government spending on economic development in Hong Kong has been relatively small it is nevertheless true that government revenue should be raised in

the least distortionary and most coherent way. Basically this involves balancing the disincentive effect of taxation against the benefits of the provision of public goods. Ho makes the obvious point that Hong Kong's low direct tax rates reduce this disincentive effect but is otherwise uncritical of Hong Kong's tax system in relation to development. He reports, for example, that earnings and profits taxes are revenue elastic with respect to G.D.P., but it isn't clear what implications this has for economic development since this simply says that taxable salaries and profits are on average growing faster than G.D.P. Since this is a characteristic of a developing economy no policy implications may be drawn. Ideally what we would like to know is how the present salary and profit taxes influence private labour and capital supply decisions, and whether government investment outweighs the assumed reduction in private saving and capital formation. These are the important issues and Ho makes no discussion of them.

With regard to the relation between the fiscal system and the distribution of income, we find that the immediate impact of direct taxation has a small effect on the equality of income. This is unsurprising since the direct tax system is only designed to be mildly progressive. If we take Hong Kong's tax system as a whole then the improvement in the distribution of income is even less marked since indirect taxes are generally regressive. In other words, the burden of taxation is broadly neutral with respect to income distribution. The secular trend, which has characterised all developing economies to a greater or lesser degree, is for the distribution in income first to deteriorate then slowly improve as national income grows. Although Hong Kong's tax system has become slightly more progressive since 1945, this is almost entirely due to an increased reliance on direct taxation. From this we may infer that the tax authorities have effectively taken a passive stance on income distribution and continue to be more concerned with increases in the absolute level of income than with its distribution.

The main features of Hong Kong's tax system may be simply described. Direct earnings and profits are classified into four categories each of which is subject to a separate tax - salaries tax, profits tax, interest tax and property tax. Alternatively, Hong Kong residents may elect to have personal assessment by aggregating income from these four sources and applying to be taxed on the same scale as for salaries. Only salaries have a progressive tax structure. Property and interest are taxed at the standard rate of 15% (although savings deposits are effectively tax free), whilst unincorporated business profits are taxed at a flat rate of 17%, after simple deductions for allowances. Thus the decision to opt for personal assessment depends on the level and composition of income. The marginal tax rates for salary income increase from 5% for incomes over \$10,000 to a maximum of 30%, with the additional constraint that the average rate of tax should not exceed 15%. There is also a progressive estate duty rising from 7% on estates valued at \$400,000 to \$500,000, to 18% on estates over \$3 million, but this is a minor source of revenue.

Indirect taxes represent 35% of government revenues and take the form of an amalgam of ad valorem and volume taxes including import and excise duties, licences and franchises, and most importantly, rates.

The net effect of this tax system is very mildly progressive which is largely due to the influence of tax thresholds on effective average tax rates. Ho, as ever, is uncritical. On balance he appears willing to allow the tax system to bask in the reflected glory of Hong Kong's successful growth, even though it has had little active influence either on development or income equality. It may well be that a small government sector and a passive tax system do encourage growth in some economies but Ho makes no attempt to demonstrate this. As a consequence he virtually ignores the possibility of any improvements to the current system. For example, Ho seems unaware that optimal tax policy, where the government is broadly neutral to income distribution, suggests that direct taxation is superior to indirect taxation from the viewpoint of allocative efficiency. As such he merely accepts the efficacy of the current tax design, and the very limited scope of his evaluation seriously detracts from his work.



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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

SPECIAL ARTICLE

WHY THE BANK OF JAPAN HAS SUCCEEDED

WHERE THE BANK OF ENGLAND HAS FAILED

A COMPARISON OF THE RECORD OF PERFORMANCE IN ACHIEVING MONEY
SUPPLY TARGETS IN JAPAN AND BRITAIN BETWEEN 1974 AND 1979.

*Text of a Speech
by*

John G. Greenwood

Editor, Asian Monetary Monitor

on December 5th, 1979

at a Conference organised by G.T. Management Ltd.

at the Carpenters' Hall, London.

During the period since the British General Election on May 3rd, there has been a deliberate effort by the authorities under the Prime Minister, Mrs. Thatcher, and the Chancellor of the Exchequer, Sir Geoffrey Howe, to bring down the rate of inflation by controlling the rate of growth of the money supply. To date, the results have been pitifully meagre.

The rate of growth of money by any definition has been persistently in excess of official targets, distressingly unresponsive to successive hikes in M.L.R., and notoriously perverse in its short term predictability. What is worse, especially to one who is sympathetic to the present government's aims, is that despite its inability effectively to restrain the growth of money the administration is being branded as "monetarist", and no doubt losing much goodwill both for itself and for the monetarist approach to dealing with inflation. The irony is that - in my view - no realistic steps have so far been taken which are likely over the next few months to solve the problem of controlling monetary growth. While I do not doubt the determination of our political leaders ultimately to control monetary growth, I am very doubtful that the authorities have the right mechanisms at their immediate disposal, and therefore I am sceptical of the likely outcome - at least as long as current monetary arrangements remain in force.

As an economist first at the University of Tokyo, and for the past five years with G.T. Management, I have been a student of monetary systems and monetary experience in the Far East. This afternoon I want to share with you some of the findings of our research, particularly with regard to the techniques of monetary control, and I shall discuss some of the implications of these oriental monetary experiences for the problems which are currently being faced in the implementation of monetary control in Britain today. From an analytical or theoretical point of view none of these findings is new; the value of comparing the experience of the Far East with our present

experience in Britain is that this research provides a body of practical knowledge derived from different monetary systems which I believe is directly relevant to the current debate in this country.

In November the Chancellor of the Exchequer issued a statement to the effect that a consultative document on the subject of reforming the monetary system with a view to enhancing the techniques of monetary control would be produced by the authorities. I believe it will be important during the debate in the months ahead to consider not only our own situation in Britain, but also the experience of other countries - both successful and unsuccessful - in this central matter of accurate monetary control. Much of our research at G.T. has been carried out under the auspices of ASIAN MONETARY MONITOR, a journal published in association with the G.T. Group. I am grateful to my colleagues at G.T. for their support in enabling me to extend these monetary studies from Japan to a wide range of countries, an exercise which over the years has added an invaluable measure of practical perspective to what would otherwise be just a matter of dry textbook logic. For, despite wide differences in local administrative and institutional detail our monetary studies in the Far East have revealed certain common, underlying principles which would appear to be generally valid, irrespective of national boundaries.

Let me set the scene by asking you to cast your minds back to 1974. In that year the inflation rates as measured by consumer price indices in both Britain and Japan reached 25% or 26% on a year-to-year basis. Both countries were experiencing difficulties in their external balance of payments: in the British case sterling was supported at around US\$2.30 with substantial official borrowings, while in the Japanese case the Yen was allowed to depreciate from around ¥265/US\$ to around ¥300. Both countries experienced a deep recession: in Britain the index of manufacturing output declined by 18.3% from its peak, while in Japan the index of industrial production fell by just over 23%. In both countries wages soared -- earnings rose by over 30% in the U.K. and by 27% in Japan. Finally and most significantly, both countries saw a marked increase in the size of their government budget deficits. In Britain the deficit tripled from 1973 to 1975, while in Japan for only the second time in the period since the end of the American Occupation the government budget switched into deficit. (In the British case the main reason was an increase in expenditures; in the Japanese case the main reason was the decline in revenues from corporation tax rather than any deliberate programme of increased government expenditure as a share of GDP.)

It is now almost six years since that rather traumatic year. How have Britain and Japan coped with the common difficulties they faced at that time?

In Britain I think it is fair to say that while there was some temporary moderation in inflation between 1975 and 1977, the trough in the inflation rate was uncomfortably high, and we are now in the midst of another inflationary surge which

most monetary analysts would associate with the rather rapid rates of M_3 growth since 1977, though it is true that some of the rise in the indices of inflation is a direct consequence of raising VAT (Value Added Tax) earlier this year. Intimately bound up with the current surge in inflation there is renewed concern about the consequences for wages. On the external front sterling has of course appreciated recently to some extent, but the current account balance is still weak despite the supposed benefits of North Sea oil. So long as this remains so the strength of sterling will be dependent upon net capital inflows (actual and expected), attracted largely by the issue of high coupon government debt rather than by the incentive of a high rate of return in a vigorous private sector. In terms of industrial manufacturing growth Britain has shown some recovery, but real output growth since 1974 has been barely 1% p.a. compared with far higher rates elsewhere. Lastly, the size of the public sector deficit remains distressingly large and obstinately unresponsive to policy actions. Both because of its potential monetary consequences and because of what it implies for the division of expenditure between the private sector and the public sector, the PSBR remains a nagging thorn in the side for the present government.

In Japan, by contrast, as you will recall, the consumer price inflation rate fell from 26% in 1974 to around 9% or 10% in 1976-77, and then in 1978-79 the rate declined to as low as 2% on a year-on-year basis. Wages, having risen by 30% in 1974, have slowed to a rate of increase as low as 6% or 7% in the past two years, very much in line with the increase in labour productivity. Industrial production growth initially recovered sharply in conjunction with an export boom in 1975-76, but slowed again in 1977, even though the economy had not yet reached full capacity utilization. In mid-1978 a genuine domestic recovery finally got underway, and by the early part of this year confidence in many sectors of industry was at last returning. Moreover since the upswing was not produced by any artificial monetary stimulus, the business expansion had all the makings of a prolonged, sustainable recovery. On the external side, the Yen appreciated sharply in 1977-78 while the domestic economy was quiet, but has now depreciated almost as dramatically since October 1978 as the current balance of payments has shifted to deficit in line with a higher level of import demand and lower demand for Japanese exports abroad. In essence the Japanese have purchased stability for the domestic economy with greater instability for the external sector - an exact reversal of the policy imposed on them by their adherence to a pegged exchange rate under the Bretton Woods System until 1971. Finally, and most strikingly, while the Japanese have by and large been successful in solving the problems they faced in 1974, there remains one outstanding area of failure. Despite repeated attempts to solve the government's budget deficit, the Japanese public sector borrowing requirement remains stubbornly large and seemingly unamenable to treatment. (See Chart 1 and also Table 1.)

- - - - -
 * Public Sector Borrowing Requirement

JAPAN

CHART 1 : GNP AND GOVERNMENT REVENUE AND EXPENDITURE

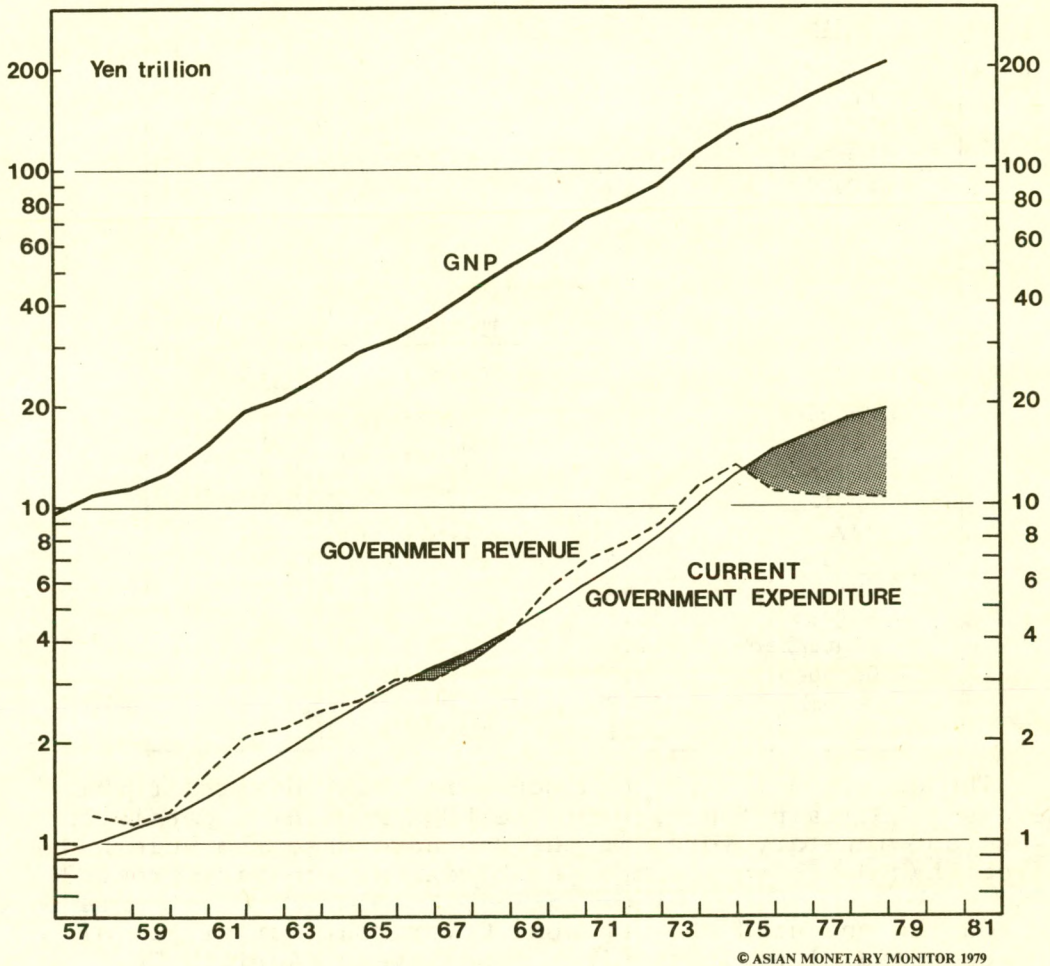


Chart 1

The chart shows the decline in the Japanese government's revenue relative to current expenditures in the years since the oil crisis, and the resulting budget deficit. The overall public sector borrowing requirement is larger than that shown here because the government's capital expenditures (not shown) are almost entirely financed by bond issues.

JAPANESE GOVERNMENT EXPENDITURE AS % OF GNP

(Calendar Years)	Government Final Consumption Expenditures	Government Gross Fixed Capital Expenditures	Total Government Expenditures
1974	9.0	8.9	17.9
1975	10.0	9.0	19.0
1976	9.8	8.7	18.5
1977	9.8	9.1	18.9
1978	9.5	9.9	19.4

TABLE 1

BUDGET DEFICITS IN JAPAN AND OTHER COUNTRIES

1978	US\$ billions	% of GNP
Japan	63.6	6.5
UK	16.1	5.2
USA	43.8	2.1
Germany	12.8	2.0
France	3.8	0.8

TABLE 2

YEAR-TO-YEAR GROWTH RATE OF JAPANESE M2

	1977	1978	1979
January	+13.1%	+10.5%	+12.1%
February	11.6	10.9	12.1
March	12.8	10.5	12.9
April	11.6	12.7	12.7
May	11.2	11.9	11.8
June	11.3	12.2	11.3
July	12.3	11.3	10.7
August	11.1	12.4	10.9
September	10.7	12.5	11.5
October	9.8	12.3	
November	10.9	12.4	
December	11.1	13.1	

The question I wish to discuss is this: How is it that whereas in Britain the size of the PSBR remains a persistent fiscal and monetary sore, in the Japanese case the huge budget deficit has not been accompanied by excess monetary growth?

On the one hand the Japanese Government deficit is of unprecedented size: in the last fiscal year (April 1978 - March 1979) it is estimated to have amounted to ¥153 trillion (£28 billion), and was equal to no less than 6.5% of GNP. Yet on the other hand the Japanese monetary authorities have been remarkably successful in keeping monetary growth to their targeted figure of 12%. From month to month the year-on-year growth rate of Japan's M₂ has seldom deviated by more than one percentage point from this figure. (See Table 2.) Bearing in mind the problems we have had in Britain when faced with similar circumstances, how can the Japanese performance be explained?

I believe the answer to this puzzle deserves serious study by students of monetary affairs. However, before I answer the question for you directly, I want to digress from my main theme for a moment to focus on two important prerequisites for the successful control of the quantity of money: namely the necessity to allow the exchange rate to float and to allow interest rates to be freely determined in the market. History is full of examples of attempts by government to peg one of these two prices, and the inevitable side-effect - failure to control the quantity of money. Let me illustrate briefly the consequences for monetary growth of the pegging or unpegging of exchange

rates from the experience of the Far East. (Time does not permit a similar demonstration of the importance of not pegging interest rates as a precondition of for controlling monetary growth, but as I shall show from the balance sheet of a typical central bank, the case is analogous.)

In the Far East, several countries have continued to peg their exchange rates rigidly to the U.S. Dollar. (See Chart 2.) As a result, those countries (Taiwan and Korea are good examples) have suffered successive balance of payments surpluses and deficits associated with the alternating consequences of episodes of monetary accelerations and decelerations in the United States. The effect has been to produce in those countries an amplified form of stop-go - a roller coaster business cycle as monetary growth in South Korea, for example, has accelerated first to over 40% per annum and then back to less than 12% within the space of little more than a single year. In short, these countries have implicitly chosen not to control their money supplies, and any public statement of a money supply target must be regarded as little more than lip service to a current fashion. During the past year Taiwan, South Korea, Thailand, and the Philippines - all countries which peg their exchange rate to the U.S. Dollar - have seen their inflation rise to double digit rates.

In Malaysia, Singapore, Australia and New Zealand the authorities have deliberately managed their exchange rates. In the case of Singapore, the policy of moving the Singapore Dollar steadily upwards against the U.S. Dollar in 1976-78 has paid off handsomely: the inflation rate is only 3 or 4% and the economy has been spared the roller-coaster experience of Korea and Taiwan.

In Australia, the authorities have unfortunately attempted to have the best of both worlds. There is a three-man team (the "three wise men") who set the exchange rate, and yet the authorities have also publicly announced specific monetary growth targets. Not surprisingly these objectives have come into conflict with one another and earlier this year the Treasurer was compelled to announce in Parliament the abandonment of the monetary growth target. Effectively therefore, Australia along with most other Far Eastern economies has controlled the price of money through an exchange rate target rather than the quantity of money.

The only economy not to control either the quantity of money or the price of money is Hong Kong, and as you might expect the result there is accelerating inflation and a currency which has been even weaker than the U.S. Dollar over the past two years. However, even if some of these countries such as Singapore, Australia and Hong Kong were to attempt to control their monetary growth rather than their exchange rate, I believe they would have severe difficulties because in each case their banking structures and their reserve requirement systems are all variants of the British-type of banking arrangements; in terms of the comparison between Britain and Japan their experience would probably resemble the British pattern rather than the Japanese.

CHART 2
EXCHANGE RATES IN THE FAR EAST

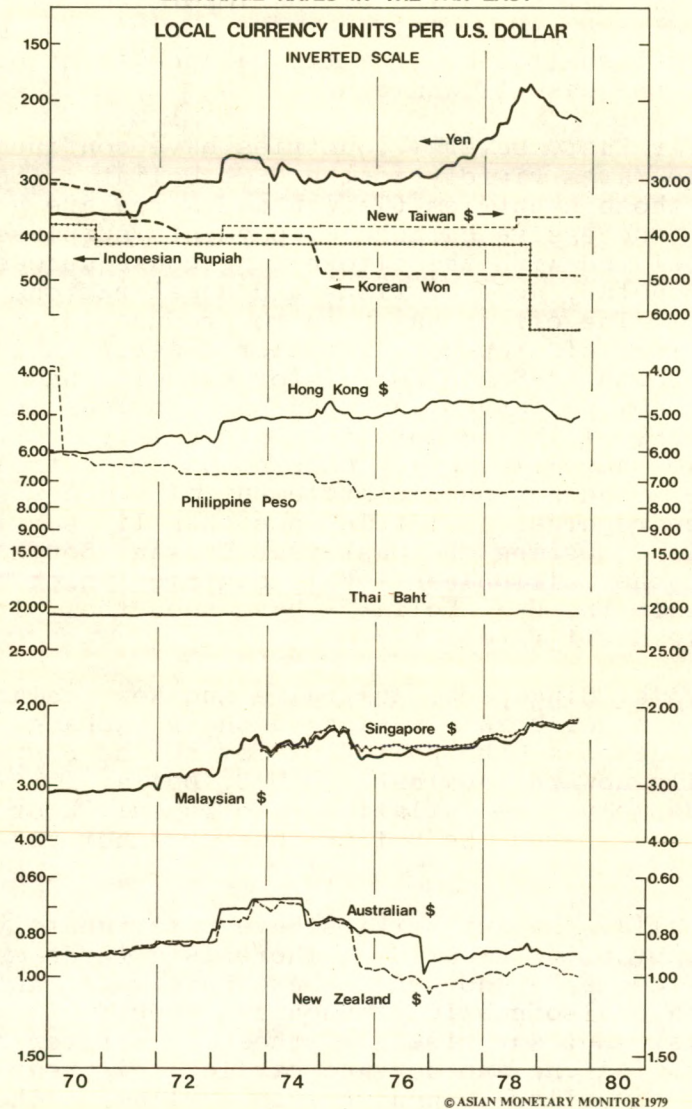


CHART 2

The countries of the Far East have followed floating, managed and fixed exchange rate policies in the seventies. All those countries which followed fixed exchange rate policies are suffering from inflation problems. The only countries which have been successful in keeping inflation down have allowed their currencies to appreciate on the foreign exchanges. Consumer prices in Japan rose only 3.6% in the year up to mid-1979, they rose only 2.8% in Singapore and 3.7% in Malaysia in the same period. In contrast Taiwan, Korea, Indonesia, the Philippines and Thailand are all suffering from double digit inflation rates.

Although a flexible exchange rate is a necessary condition to insulate a country from inflation elsewhere, it is not sufficient, as the example of Hong Kong illustrates. The Hong Kong authorities control neither the exchange rate nor the money supply with the result that inflation has become a serious problem and the currency has been weak.

I return therefore to my main topic - what is the essential difference between the Japanese and British banking systems? What has enabled the authorities in Japan accurately to control monetary growth despite the budget deficit while the British authorities have apparently been repeatedly frustrated in their attempts to control monetary growth?

There are those who are inclined to shrug their shoulders and dismiss the difference in performance as due to differences of national character, or attitudes of mind. But if that is so, one must conclude either that the Japanese national character has undergone a radical change since July 1974 (the date when monetary targets were first introduced), or that it will require a reform of our national character in Britain in order to achieve a monetary reform. Neither of these propositions seems to me to deserve much support. On the contrary, I think that a careful review of the technical requirements governing banking practices in Britain and Japan will reveal crucial differences between the two systems which are the key to understanding the gap in monetary performance in the two countries.

I now come to the key part of my presentation. The world today has two basic types of banking system: banking systems with a simple reserve asset structure, and those with a multiple reserve asset structure. Table 3 sets out simplified balance sheets for these two systems. The three balance sheets on either side represent in simplified form the interrelationship between the Central Bank in each kind of system, the commercial banks and the non-bank public. Starting at the bottom left hand side, the focus of our concern is the quantity of money held by the non-bank public. In modern developed economies by far the largest part of the money supply is in the form of bank deposits, which of course are a liability of the commercial banks. In countries which operate a simple reserve asset system the commercial banks are required to hold some combination of cash currency (or vault cash) and deposits at the central bank in a specified ratio to their deposit liabilities. These reserve assets are in turn liabilities of the Central Bank. Therefore in order to control the quantity of deposits or their rate of growth the central bank must regulate its issue of those liabilities which count as reserves for the banks. In practice the central bank has a choice between purchasing gold or foreign exchange (A1), government securities (A2), or liabilities of the private sector (A3).

There has been much debate in the history of monetary analysis over whether it matters for monetary policy which of these assets the central bank buys. For our purposes all that we should note is that, of necessity, central bank purchases or sales of foreign exchange affect the external price of the currency, while purchases or sales of either of the other two types of assets necessarily affect interest rates, i.e. the price of whatever particular credit instrument the central bank is using to conduct its operations. In other words, in order to control the quantity of money the central bank must be willing to allow the price of money expressed in these two ways to fluctuate.

TABLE 3

SIMPLIFIED BALANCE SHEETS FOR COMPARISON OF 2 TYPES OF BANKING SYSTEM

SIMPLE RESERVE ASSET STRUCTURE

(Examples: USA, Japan)

Central Bank

A1. Gold and foreign exchange	A4. Notes and coin
A2. Government securities (inc. Treasury Bills etc.)	A5. Deposits of commercial banks (=B2)
A3. Private Sector debt (inc. commercial bills, direct loans to banks etc.)	A6. Capital accounts and other items (net)

Commercial Banks

B1. Vault cash	B4. Deposits
B2. Deposits at central bank (=A5)	(=C2)
B3. Loans and Investments	
	B5. Capital accounts and other items (net)

Non-Bank Public

C1. Cash currency	C5. Borrowings from banks (=B3)
C2. Deposits at commercial banks (=B4)	
C3. Other financial assets	C6. Net worth
C4. Other assets	

TABLE 3 contd.

MULTIPLE RESERVE ASSET STRUCTURE

(Examples: UK, Australia, Canada)

Central Bank

D1. Gold and foreign exchange
D2. Government securities
(inc. Treasury Bills etc.)
D3. Private Sector debt
(inc. commercial bills,
direct loans to banks etc.)

D4. Notes and coin
D5. Deposits of
commercial banks
D6. Capital accounts
and other items
(net)

Commercial Banks

E1. Vault cash
E2. Deposits at central bank
E3. Treasury Bills and other
maturing government
securities
E4. Loans to money market
(e.g. Discount Houses)
E5. Commercial Bills etc.
E6. "Special" deposits at
central bank

E7. Loans (or overdrafts
granted) and investments

E8. Deposits or
"eligible liabilities"

(=F2)

E9. Capital accounts
and other items (net)

Non-Bank Public

F1. Cash currency

F2. Deposits at
commercial banks (=E8)

F3. Other financial assets

F4. Other assets

F5. Borrowings from
banks

F6. Net worth

In essence this simple reserve asset system provides the central bank with direct control over the available reserve assets of the banking system. Therefore if the banks' deposit-to-reserve ratio is stable, and if the non-bank public holds a fairly stable ratio of deposits-to-currency (as seems to be the normal case in almost all developed economies where this phenomenon has been studied), then the central bank has a fairly straightforward lever with which to control the quantity of money, provided of course, that the central bank is not also under some obligation to peg either the exchange rate or interest rates.

This simple reserve asset system is the one which operates in Japan, and, as illustrated in Chart 3, it is clear that in recent years the Bank of Japan has expanded or contracted its holdings of assets A1, A2 or A3 so that although the component sources of the base have shifted, the growth of the total base has been compatible with whatever monetary target the authorities have set.

Turning now to the multiple reserve asset system which operates in Britain and is prevalent in formerly British-administered territories such as Hong Kong and Singapore, there is no such exact correspondence between the assets which the banks are required to hold as reserves (or liquid assets) and the liabilities of the central bank. In the British-type of system commercial banks are required to hold certain assets in some specified ratio to their deposits (or to some more broadly defined total such as "eligible liabilities"), but these assets are defined to include not only liabilities of the central bank but also certain liabilities of the government as well as certain liabilities of the private sector. Naturally, because the central bank does not control either the absolute quantity of these instruments that is available at any time, or the proportion of these instruments that happens to be purchased by the commercial banks rather than by the non-bank public, it cannot accurately predict the amount of reserve assets that the banks will actually hold, or the resulting size of their deposit liabilities.

If we look at the specific case of the U.K. banking system, control of the money supply by the Bank of England through the requirement that banks hold a variety of liquid assets as reserves is further complicated because:

- i) two types of assets, vault cash (E1) and "special deposits" at the Bank of England (E6) are specifically excluded from the definition of reserve assets, despite the fact that these are direct liabilities* of the Bank of England, and
- ii) there exist other supplementary constraints which, for example, try to limit the use of private sector liabilities as reserves by either the banks or the discount houses which operate as intermediaries between the Bank of England and other U.K. banks.

- - - - -
* Direct liabilities of the central bank held by commercial banks in a multiple reserve asset system are shown within the dashed line rectangles in Table 3.

JAPAN
CHART 3 : SOURCES OF THE MONETARY BASE

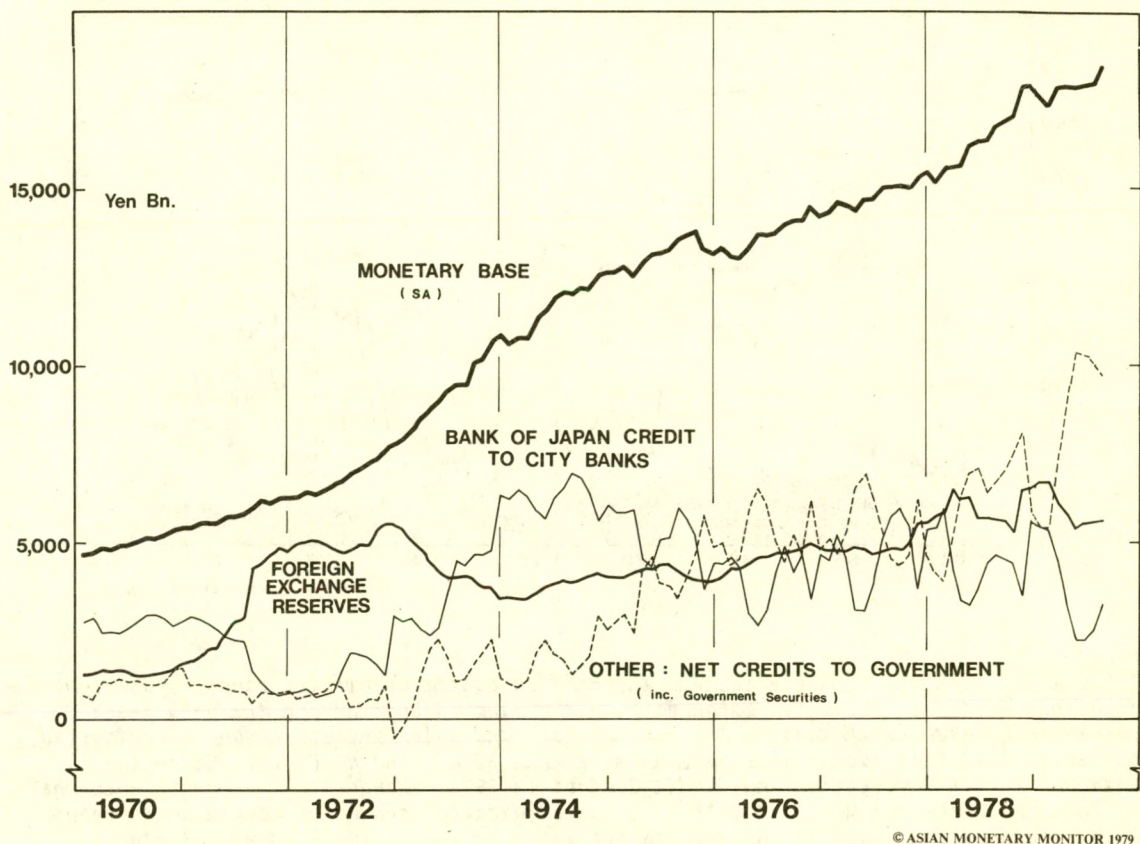


CHART 3

The Bank of Japan has successfully controlled the growth of the monetary base despite large fluctuations in foreign exchange reserves and a very large government budget deficit. This was achieved by regulating the supply of reserves or credit to the city banks (A3) to offset changes in both foreign exchange reserves (A1) and central bank lending to the government (A2). No government paper can be used as reserves by the banks, and reserves can only be created by the Bank of Japan.

N.B.: The monetary base shown here is not adjusted for changes in reserve requirements. Also, foreign exchange reserves are valued at their current (spot) market value rather than at their cost as would be proper for the purpose of showing the amount of base money created or destroyed through central bank actions in the foreign exchange market. These details of valuation do not however affect the issue of principle illustrated here.

UNITED KINGDOM

CHART 4: PERCENTAGE COMPOSITION OF UK BANK RESERVE ASSETS

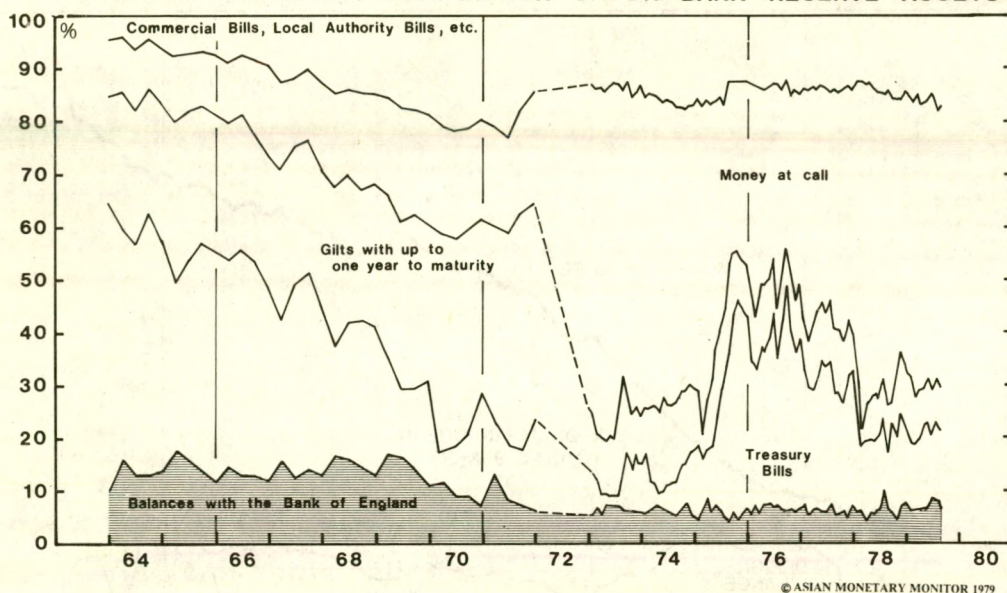


CHART 4

In contrast with the Japanese system, the British system allows the banks to use several types of assets as reserves. Balances with the Bank of England are the only reserve assets which are liabilities of the central bank and which therefore can be controlled, but since 1972 they have rarely made up more than 8% of bank reserves. Since the introduction of Competition and Credit Control in 1971, changes in the banks' holdings of Treasury Bills and Money at Call have varied greatly, and banks have usually been able to offset shortages of any one reserve asset by increasing holdings of others. N.B. In the years prior to 1972 holdings of liquid assets by the discount houses have been excluded.

UNITED KINGDOM

CHART 5: GROWTH OF M_3 , MONETARY BASE AND RESERVE ASSETS OF BANKS

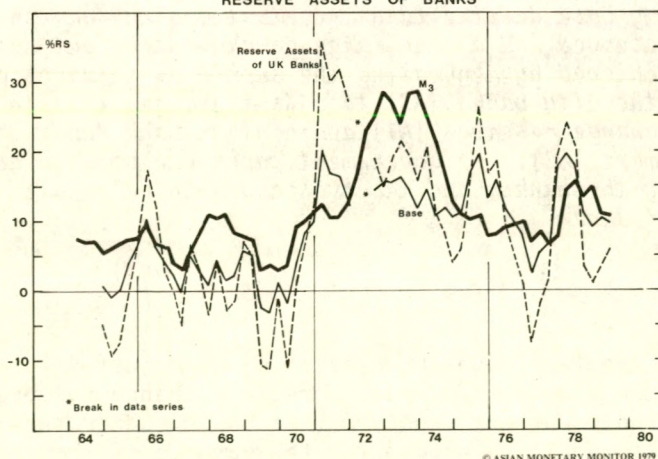


CHART 5

The growth in the reserve assets of U.K. banks has been very erratic in recent years. The monetary base has fluctuated less violently because the other component of the base (cash currency held by the public) is generally much more stable. Discrepancies between the rates of growth of the base and M_2 are accounted for partly by changes in the monetary multiplier and partly by slight differences in the coverage of the statistics.

Variations in the composition of the reserve assets actually held by U.K. banks in recent years are shown in Chart 4. The notable features are - first, the variability in the composition of the reserve assets, second, the large size of public sector debt (i.e. Treasury Bills and government securities with less than one year to maturity) as a component of reserve assets after 1972, and finally the smallness of the proportion of reserve assets actually controlled by the Bank of England. Whereas the Bank of Japan (or the Federal Reserve System in the U.S.A.) can and does control 100% of the reserve base of the banking system, in the British case the Bank of England has only ever controlled 18% of the reserve assets (in 1965), and in recent years since the explicit adoption of monetary targets, it has only controlled about 6% or 7% of the banks' reserve assets. (This amounts to only 0.75% ($=12.5 \times 0.06$) of the banks' eligible liabilities.) The Bank of England's lack of control over the base is illustrated by the wide fluctuations of U.K. banks' reserve assets and of the monetary base shown in Chart 5. Whatever the intentions of the authorities vis-a-vis M_3 or inflation, the huge swings in reserve assets cannot surely have been a result of deliberate policy.

Because of the inherent problems with their system, the authorities in Britain devised a supplementary special deposits scheme (often referred to as the corset) which was introduced in December 1973 and has operated on and off ever since. In my view this scheme along with the original special deposit system itself and the ratios applied to the discount houses' assets, are all attempts to patch up a fundamentally bad system of monetary control.

To return to the fundamental question I posed earlier: How is it that the Bank of Japan has succeeded in controlling monetary growth so accurately despite the huge deficit? The answer is that whereas in those countries which have a British-type banking system with a multiple reserve asset structure, a budget deficit financed by instruments which qualify as reserves for the banks is an almost certain way to produce faster monetary growth, in the Japanese-style simple reserve asset system the issue of government debt need have absolutely no impact on the reserves of the banking system. Thus while budget deficits in this country have almost invariably been accompanied by the threat of accelerated monetary growth, there is no such direct or even necessary consequence under a simple reserve asset system.

In closing I would like to consider with you the basic intellectual or institutional origins of the somewhat complex and certainly inappropriate method of monetary control which has evolved in Britain. As a hypothesis I would offer the following suggestion: much confusion in economic or financial affairs arises from a failure to define one's terms. In the present case the confusion concerns the word "liquidity". There are two quite distinct senses in which the word is popularly used, and it is vital to separate them. First there is liquidity as applied to an individual bank or other financial institution. Liquid in this sense means either that the bank

or finance company has prudently matched the maturities of its assets and liabilities, or that a significant proportion of its assets are of very short maturity and hence easily realizable (i.e. marketable). Second, liquidity is sometimes used in reference to the financial system as a whole. Typically when interest rates are low and the yield curve is upward-sloping, people say that the financial system is highly "liquid". Conversely when interest rates are high and the yield curve is inverted fears are expressed that the system is "illiquid".

Under the 12½% reserve assets scheme U.K. banks are required to observe and maintain certain types of reserve asset ratios. These requirements were introduced in 1971 for purposes of monetary control, but in effect the ratios were merely an extension of the minimum prudential standards provided for under previous agreements between the Bank of England and the London and Scottish clearing banks which required these groups to observe "cash" and "liquidity" ratios. "Liquidity" in this prudential or balance sheet sense, however, had nothing to do with liquidity in the aggregate or macro-economic sense.

Liquidity in the broader sense refers to the quantity of money in relation to the volume of goods and services produced by the economy. In this sense "excess liquidity" occurs when the supply of money persistently grows more rapidly than the demand for it at any given overall price level. In the early stages the greater quantity of money available leads to lower interest rates. At the next stage business activity is stimulated as spending increases. The ultimate result is a general rise in prices (as well as wages, rents, interest rates etc....). If the growth of the money supply now slows down this is typically accompanied by a further rise in interest rates and a "credit crunch" or "liquidity squeeze".

The way to avoid inflation, therefore, is for the monetary authorities to design a system which regulates or controls liquidity in the second sense i.e. the quantity of money relative to the quantity of goods and services produced in the economy. In order to avoid runs on banks, or to ensure prudent banking behaviour, or to protect depositors from loss, or to prevent bankers from overextending themselves to individual borrowers it may or may not be regarded as desirable to specify other capital ratios and restrictions. But even the most complex and far-reaching controls on liquidity in this balance sheet sense provide absolutely no guarantee that there will not be excess liquidity in an aggregate, macro-economic sense. As we saw in the British monetary expansion of 1972-73 even though every single bank conformed to the liquidity requirements, the stability of the financial system as a whole was nevertheless threatened more by the general disturbances that accompanied inflation resulting from excess liquidity in the second sense than by any individual instance of illiquidity in the first sense.

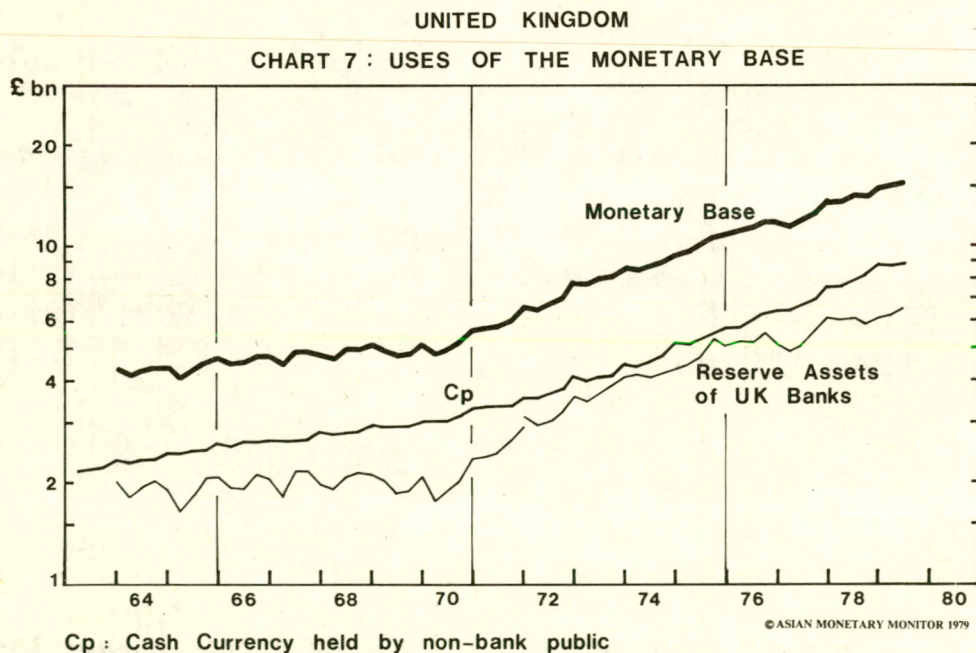
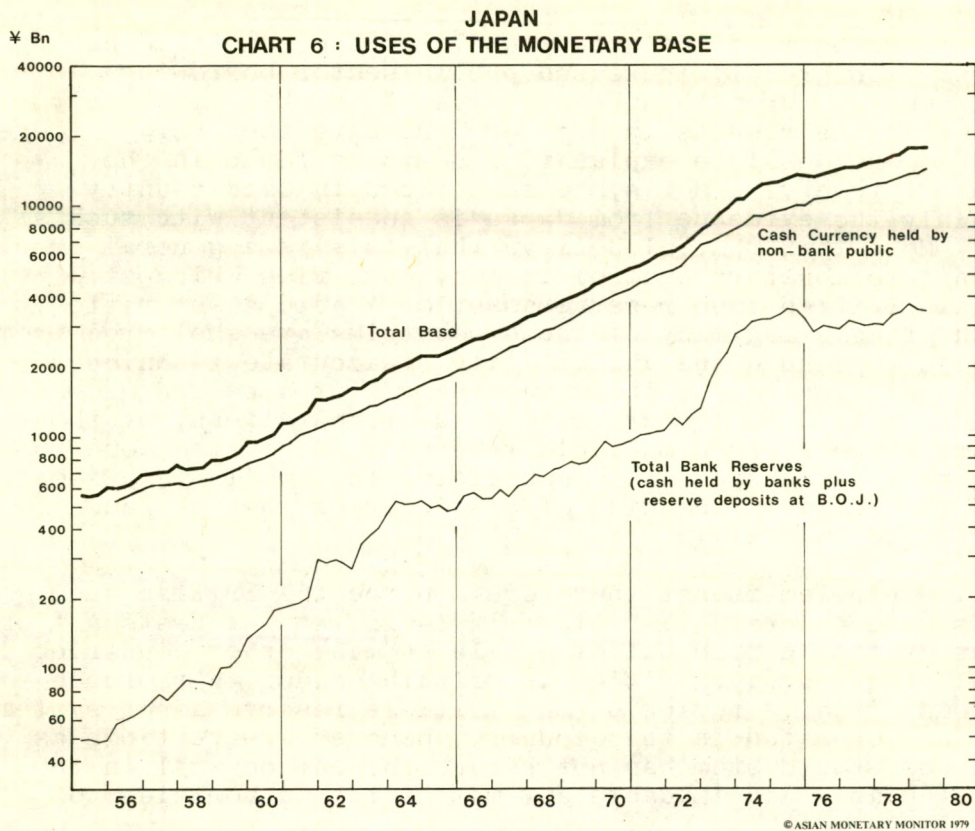
To conclude - the authorities in Japan and Britain have both been faced with similar problems in the past five or six years. Both have attempted to control monetary growth in

order to bring down inflation, while at the same time having to deal with greatly increased public sector borrowing requirements. From this brief survey I think it is fairly clear that the results in each country have been very different, and that one possible explanation is to be found in the different reserve asset systems enforced in each country. Certainly the evidence from Japan is consistent with such a view. More than that, I believe that this is a general problem relevant to monetary control in many countries which still maintain British-type reserve asset or liquid asset ratios. For the time being many of these countries are sheltered from the need to ensure the availability of accurate techniques of monetary control by their maintenance of a pegged or managed exchange rate, but I venture to predict that if any of those countries operating a multiple reserve asset system were to unpeg their exchange rates completely, they would very soon be faced with exactly the kind of difficulties that we have experienced in Britain.

The problem is not therefore a parochial British one, but is more general. I believe it is in the interests not only of the British people but of people in many other countries as well that our authorities in Britain conduct a thorough and comprehensive review of the multiple reserve asset system as it has operated in this country, because, regrettable as it may be, the system has not served the nation well in the understandable and laudable attempt of the authorities to control the money supply.

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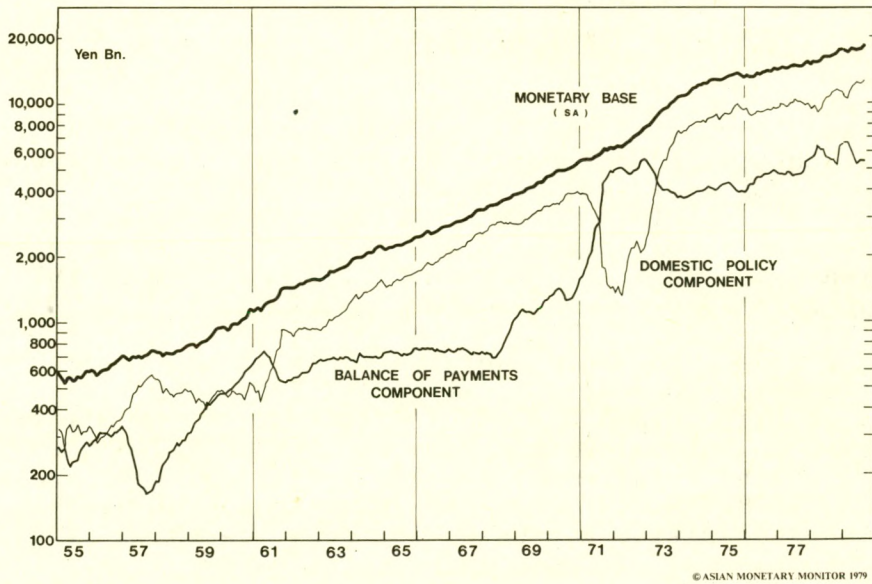
(Additional charts accompanying this speech appear on pp. 18-19.)



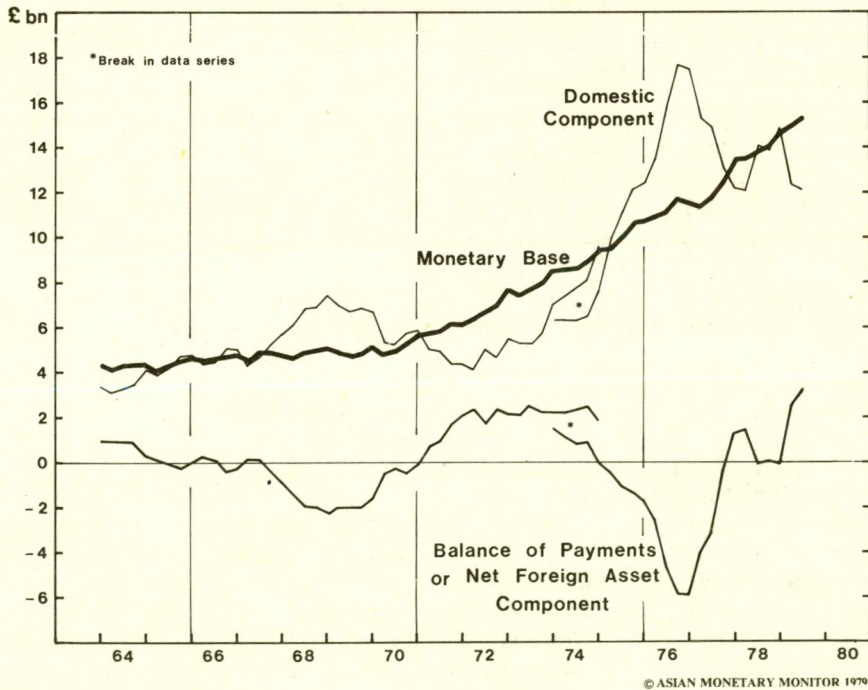
CHARTS 6 and 7

The total monetary base is obtained by summing its uses: Cash currency held by the non-bank public plus bank reserves.

JAPAN
CHART 8 : MONETARY BASE AND COMPONENTS



UNITED KINGDOM
CHART 9 : MONETARY BASE AND COMPONENTS



CHARTS 8 and 9

The sources of the base can be divided into two components: a balance of payments or net foreign asset component (corresponding to A1 in Table 3), and the residual domestic component (corresponding to A2 plus A3 in Table 3). This presentation illustrates the extent to which base money is created from "foreign" or "domestic" sources.

AUSTRALIA

BUDGETARY STRATEGY UNDERMINED

The basic thrust of the August budget for 1979-80 was to confirm the Australian government's anti-inflationary stance. Following two years of deceleration in consumer prices, which were down to 8.2% in 1978/79 as compared with 13.8% in 1976/77, progress towards a more stable price level was threatened by a rapid increase in the rates of growth of M_3 from 8% in 1977/78 to 11.8% in 1978/79.

A major reason for this increase was that the Commonwealth government's actual budget deficit of A\$3.5 billion was some A\$700 million higher than had been estimated. After allowing for net overseas borrowings the Commonwealth government's domestic borrowing requirement was A\$2.1 billion, an increase of 30% on 1977/78. However non-bank private sector purchases of government securities accounted for only one third of the financing of this deficit as compared with more than 80% in the previous year. Since government liabilities as well as Reserve Bank liabilities count as reserve assets in the Australian banking system, sales of government securities to the Trading Banks (primarily in the form of Treasury Bills) contributed to an increase in the rate of growth of domestic component of the Australian monetary base.

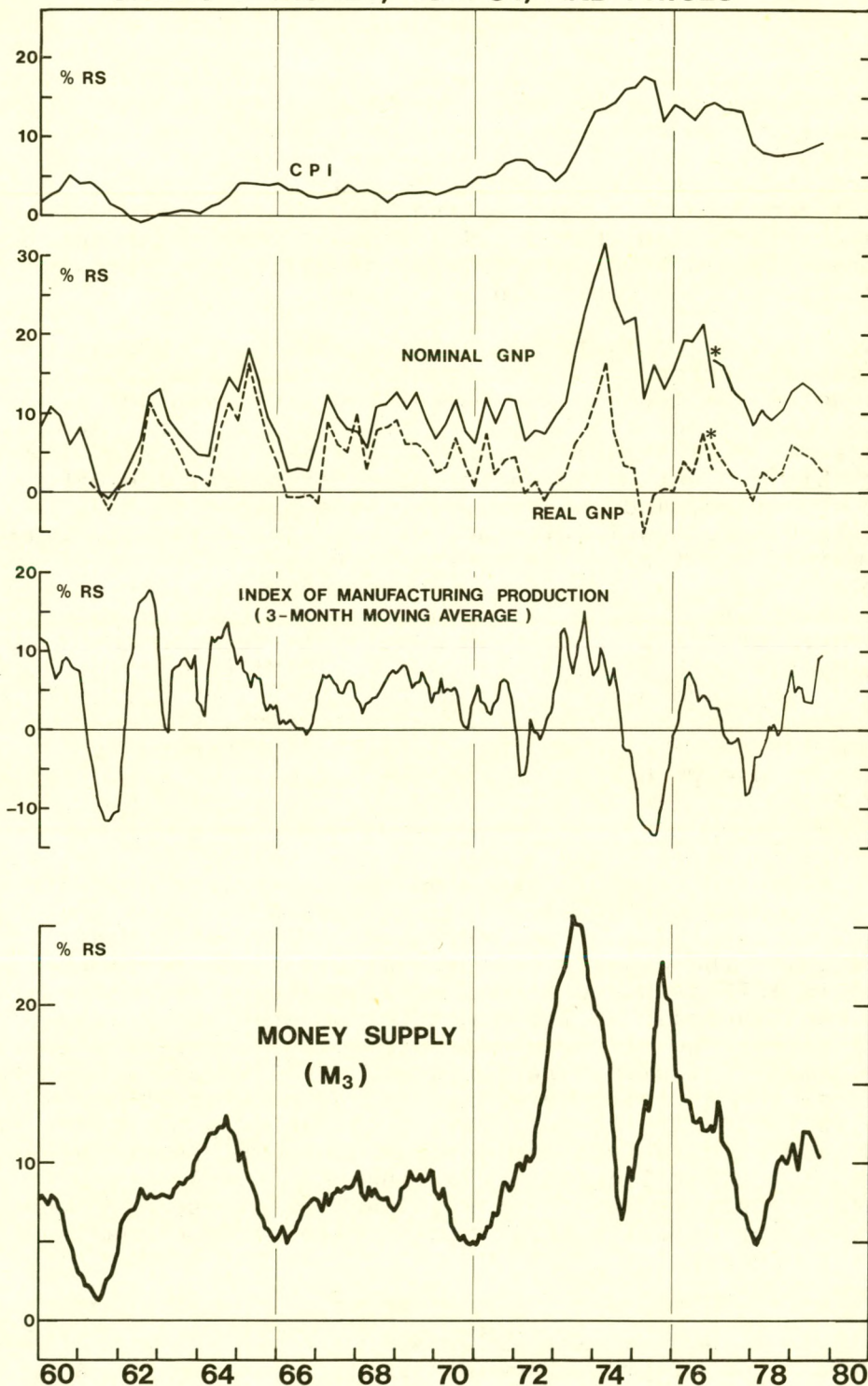
As may be seen from Chart 3, with the exception of the first quarter of 1977, the year-on-year growth rate of the domestic component of the monetary base had fallen in every quarter since the end of 1975. In the second quarter of 1978 this fall was reversed, and this reversal contributed to an increase in the rate of growth of the total monetary base and led to a multiple expansion in the size of bank balance sheets and in the rate of increase in M_3 . (See Chart 2.)

So as far as a monetary analysis of the 1979/80 Australian budget is concerned, the backdrop was one of domestically induced expansion. Turning to the foreign sector, and in particular the foreign component of the total monetary base, it is clear that the Australian Government expected both the trade account and the private capital component of the balance of payments to be strong in 1979/80. In the first five months of 1979 Australian exports increased 29% over the same period in 1978, and the growth in agricultural output and the increase in commodity prices led to a rapid turnaround in the decline in Australia's balance of trade account that had occurred in the previous year. On the capital account, Australia experienced a net capital inflow of some A\$2.9 billion in 1978/79, an increase of approximately 25% on 1977/78, as illustrated in Chart 6.

Against this background of a strengthening trade account and an external acceleration in capital inflow, it was clear that the government would have to restrict the domestic component of the monetary base in order to achieve its target

AUSTRALIA

CHART 1: MONEY, OUTPUT, AND PRICES



*Change of data series.

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of keeping the rate of increase of M_3 below 10% in 1979/80. Accordingly the estimated budget deficit for 1979/80 was reduced by A\$1,285 million to A\$2,193 million which after foreign borrowings, left a projected deficit of A\$875 million to be financed domestically. Essentially the success of this original budget strategy was conditional upon a projected US recession in late 1979. Because that slowdown did not materialise, two developments have now occurred which have served to undermine these budgetary assumptions.

First there has been a steep increase in the price of Saudi Arabian light crude oil, and second the interest rate differential between Australia and the US has widened. Both these two developments could have surprisingly significant effects on the monetary base in the months ahead.

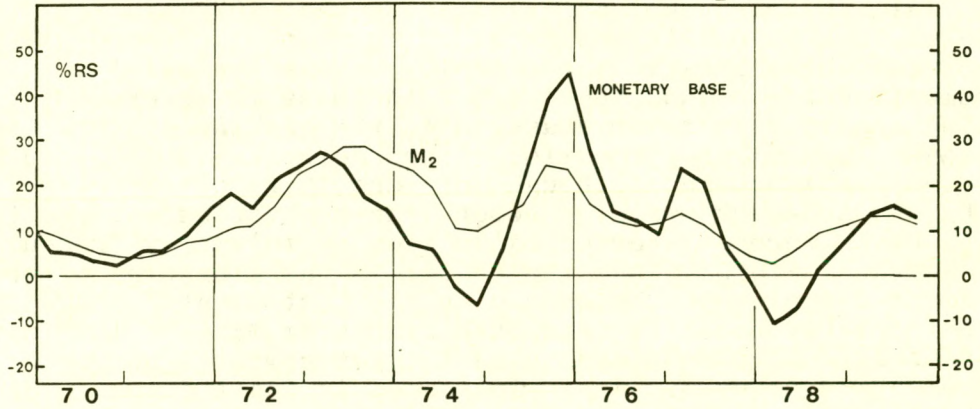
The first major factor - the increase in oil prices - means a substantial increase in government revenues from the oil levy, thus reducing the federal government's deficit and domestic borrowing requirement. The budget projected that revenue from the crude oil excise would raise A\$2,057 million during 1979/80. However this was estimated on the assumption that the OPEC pricing structure, and in particular the price of Saudi Arabian light crude which is the marker price for Australian oil, remained constant. The recent increase in the Saudi oil price will lead to an increase in government revenues of between A\$750 and A\$900 millions and a corresponding reduction in the government's deficit. In a multiple reserve asset banking system such as Australia's it is difficult to predict precisely where and how changes in the government deficit will have an impact on the monetary base. Broadly its effect will depend on whether the government deficit is financed by domestic or foreign borrowing and the composition of domestic lenders.*

If one compares Chart 3 and Chart 5 it is clear that the absolute size and rate of change of the government deficit has a variable impact on the size and rate of increase of the domestic component of the monetary base. In comparison with 1975 and 1976, the equally substantial rise in government spending in 1978 produced a much smaller, but nevertheless significant, increase in the domestic component of Australia's monetary base. The difference is due to the changes in the way the government deficits were financed. In 1974 and 1975 more than 80% of the deficits were financed by domestic borrowing whereas in 1978 half the deficit was financed by borrowing from overseas and a third from the government's own cash balances. Only 20% of the total deficit was financed by sales of government securities to the Australian private sector, thereby reducing the potentially inflationary effects of excessive government spending.

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* If the whole of the government deficit was financed by the sale of government securities to the non-bank private sector, the size of the government deficit has no necessary effect on the size of the monetary base. Economies such as the US and Japan avoid the possibility of expansionary monetary consequences as the result of their fiscal deficits because in these countries government liabilities are not counted as reserve assets.

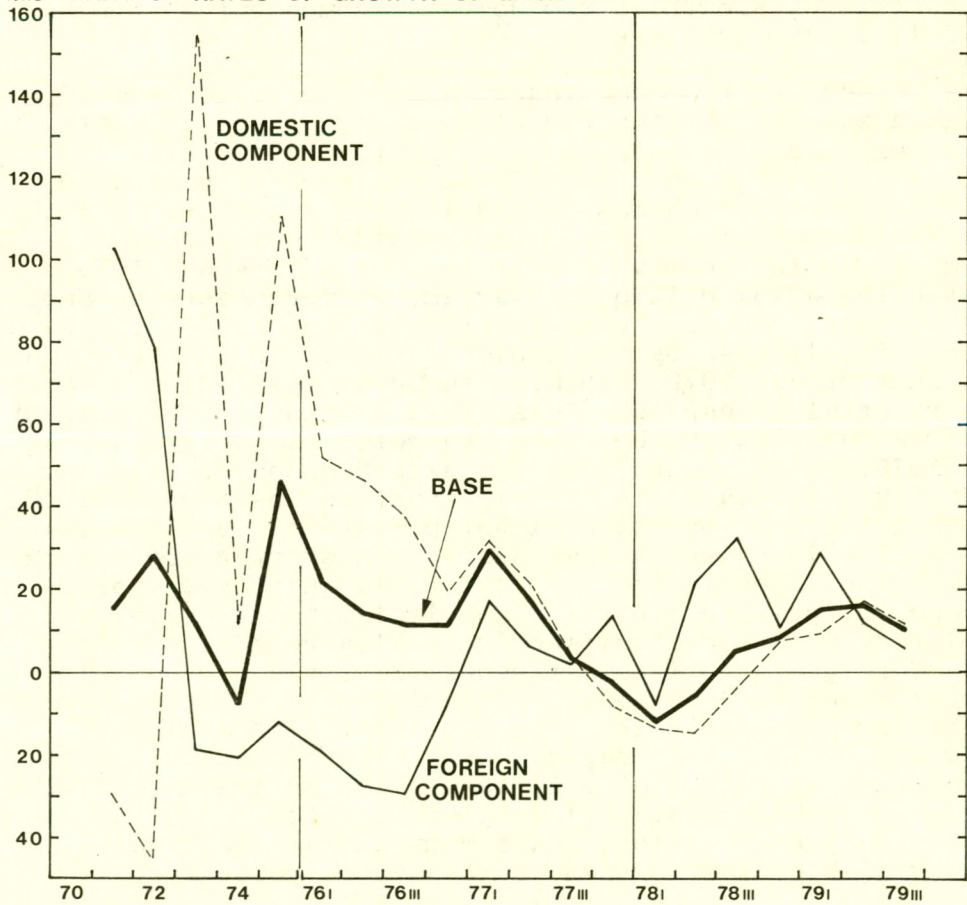
AUSTRALIA
 CHART 2
 IMPACT OF THE MONETARY BASE ON M_2



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AUSTRALIA

CHART 3: RATES OF GROWTH OF MONETARY BASE AND COMPONENTS



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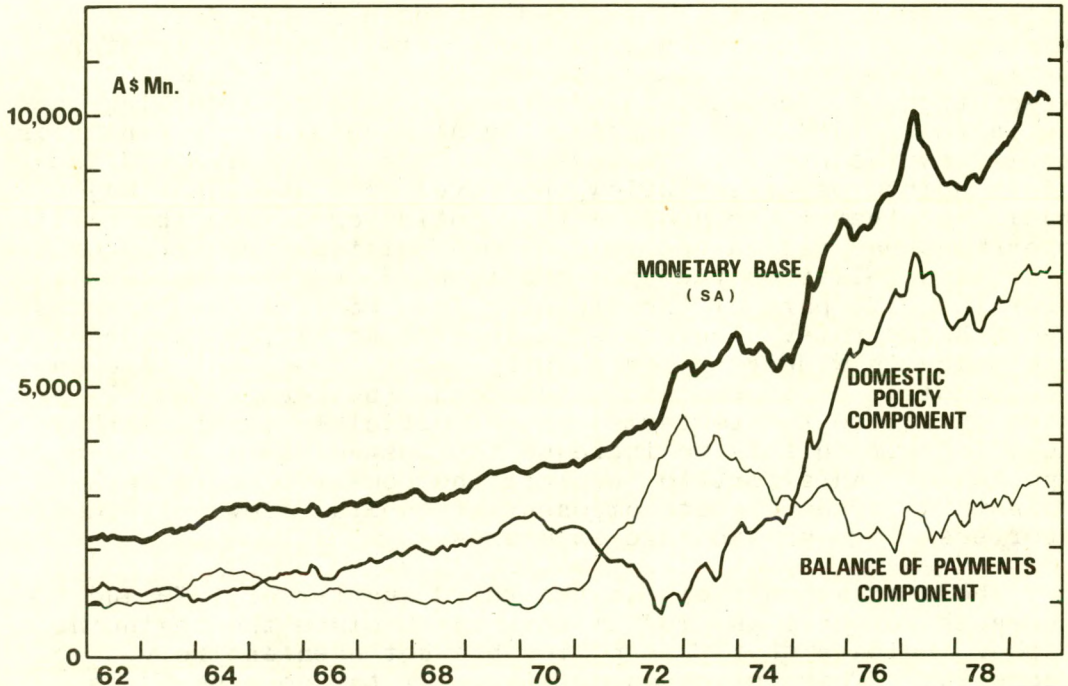
Changes in the maturities of the government debt used to finance the domestic borrowing requirement also have important implications for monetary growth in the coming year. The uneven fall in the budget deficit in 1976 and 1977 was not reflected in a change in the level of the domestic component of the monetary base because the majority of the financial instruments used to fund the earlier increase in government spending remained as reserve assets in the banking system. In 1977-1978 a smaller proportion of the deficit was financed by domestic borrowing, and although only one third of this was lent by the non-bank private sector, the securities sold to the Trading Banks were of shorter maturities (principally Treasury Notes*) than in 1975. Thus the change in the financing of the government deficit and the change in the instruments used will reduce the likelihood that the banking system will be left with an "overhang" of reserve assets as the government's borrowing requirement is reduced. As is indicated in Chart 5 the prospective reduction in the government's financing requirement is very significant, and if the whole of the increase in oil revenues is used to reduce the domestic borrowing requirement, the combined impact of these factors will lead to a significant reduction in the domestic component of the monetary base. Chart 3 shows that this process is already beginning to occur with the rate of growth in the domestic component showing its first fall in six quarters.

The second major assumption on which the budget for 1979-1980 was framed was the maintenance of a strong external position. The Treasury expected the balance of payments would exhibit a billion dollar turnaround in 1979/80 compared with 1978/79. Whilst this expectation has proved justified with respect to the current account position which showed a deficit of A\$550 millions in the five months ending in November 1979 (representing a A\$1 billion dollar improvement over the same period in 1978) the government's expectations would appear to have been invalidated by the capital outflow in the third and fourth quarters of 1979. In many respects the size and timing of the reversal in capital flows is surprising. The interest rate differential with the US has narrowed steadily since the end of 1976, during which time the A\$/US\$ exchange rate has varied within a relatively narrow band (see Chart 6), yet this had no significant impact on either private or total capital flows until 1979 by which time Australian short rates had been less than the US equivalent rates for two quarters. Moreover the scope for private capital flows is limited by Exchange Control regulations prohibiting Australian residents from holding foreign fixed interest securities, and by the characteristics of Australian trade financing, 70% of which is in US dollars. Nevertheless, in the first five months of 1979/80 the net apparent capital outflow was A\$90 million, compared with an inflow of A\$1,310 million in the five months ending in November 1978. This has contributed to an increased balance of payments deficit and a commensurate decline in the rate of growth of the foreign source of the monetary base.

* The Federal Government sold A\$1 billion new Treasury Notes in 1978/79, compared with a net reduction in outstanding Treasury Notes in 1977/78.

AUSTRALIA

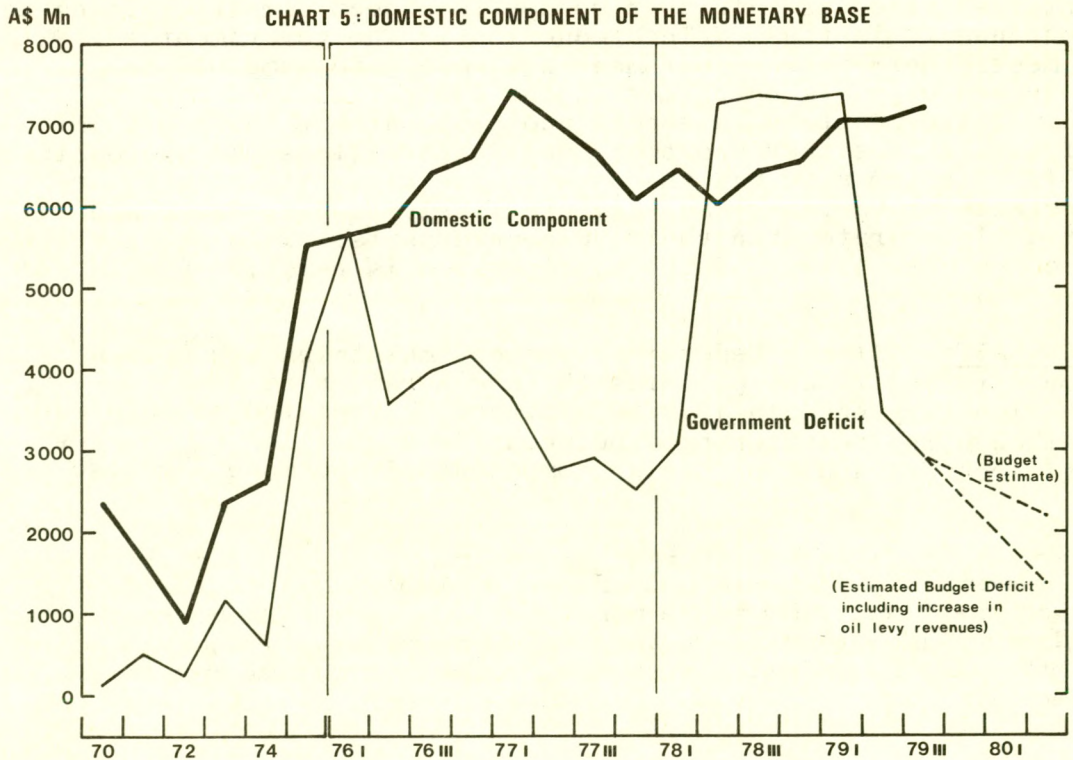
CHART 4 : MONETARY BASE AND COMPONENTS



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AUSTRALIA

CHART 5 : DOMESTIC COMPONENT OF THE MONETARY BASE



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A rise in interest rates sufficient to establish a yield spread in favour of Australian short rates over their US counterparts could presumably stem the short term capital outflow and contribute to reduced slowdown in the rate of growth of the monetary base, thereby permitting the monetary aggregates to move in line with the government's budget expectations.* However, in addition to placing a ceiling on the increase in M_3 and managing the A\$ exchange rate (which is itself contradictory), the government has also attempted to maintain interest rates below the level of Australia's major trading partners. To achieve this policy objective the government has relied entirely on manipulating the value of the Australian dollar on the spot and forward currency markets in order to shift part of the pressure from US interest rates onto the exchange rate. They have engineered an A\$/US\$ exchange rate which is widely believed to be undervalued, and have cut the US dollar to a substantial discount (between 3% and 5% per annum in interest rate terms) on the official forward market. The effect of this is to increase the cost of forward cover to exporters in an effort to insulate the domestic money markets against the trade credit component of capital flows by reducing exporters' foreign exchange exposures.

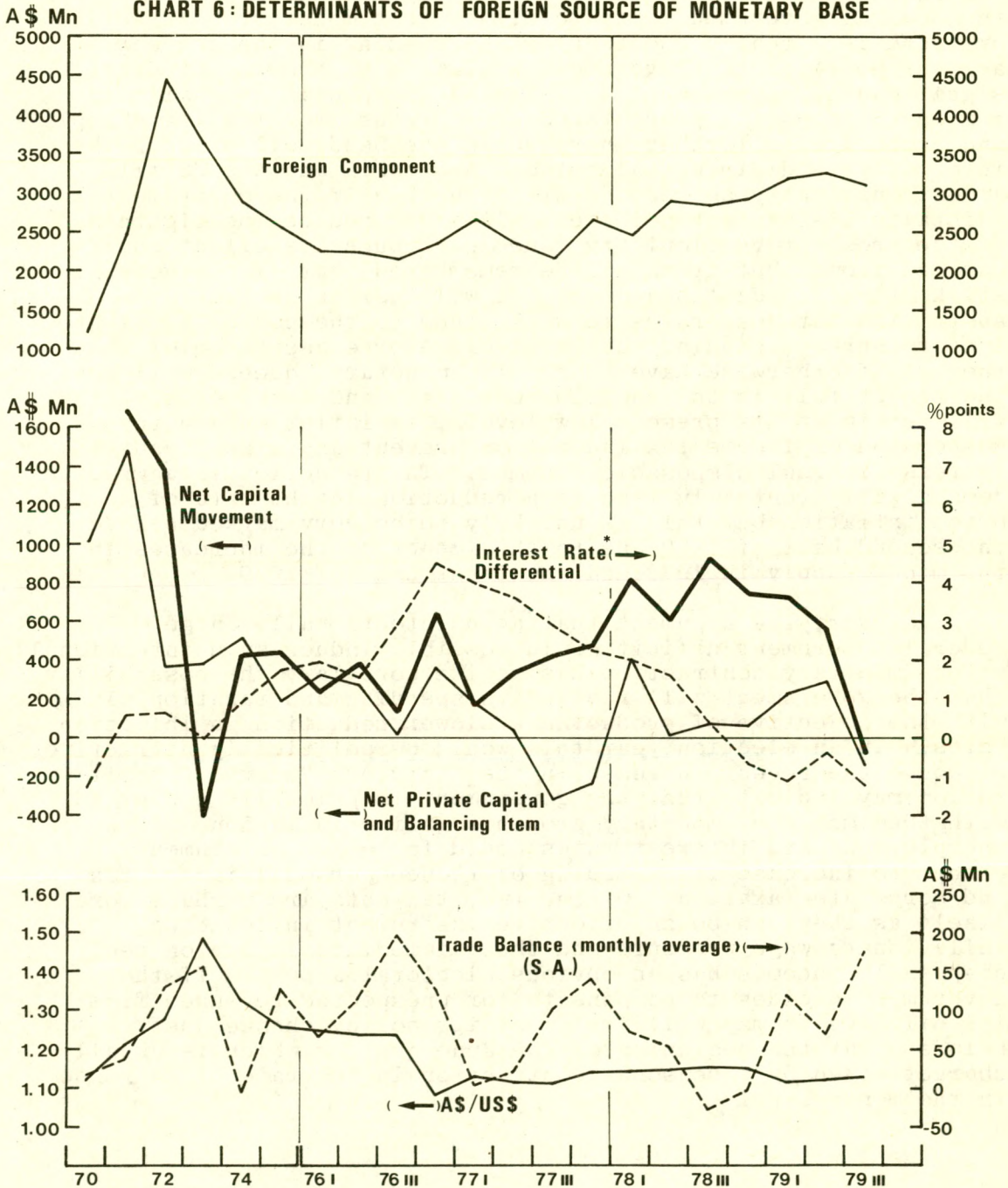
The capital outflows in the third quarter of 1979 and the increases in short and medium term rates since the beginning of October indicate that this policy has not been entirely successful. This is not surprising. If the government is intent on reducing inflation then interest rates must eventually be allowed to adjust to changes in the rate of increase in the monetary aggregates. That the government's expectations of a capital inflow have been thwarted by rising international interest rates is a further reason to expect domestic yields to continue to increase. The reduction in the government's domestic borrowing requirement will mitigate some of the downward pressure on prices in the Australian bond market, but if the monetary base continues to contract the possibility of a fall in either short or long rates will become increasingly slim. In the same way that Australian rates lagged the increase of US rates, so they are likely to peak later and fall at a slower rate than their US counterparts. This possibility becomes more likely if the US recession is relatively mild.

FORECAST: If the Federal government maintains its current monetary and fiscal policies the acceleration of the monetary base in 1978/79 will not be repeated in 1979/80. Although the relationships between the Australian-US interest differential and the foreign component of the monetary base,

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* However a rise in interest rates would also encourage the sale of government securities to the non-bank private sector thereby reducing the Trading Banks' potential acquisition of reserve assets and to some extent offsetting the expansionary stimulus to the monetary base from the capital account.

AUSTRALIA

CHART 6: DETERMINANTS OF FOREIGN SOURCE OF MONETARY BASE



*The yield difference between US and Australian 90 day Treasury Bills

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and the government deficit and the monetary base's domestic component, are not particularly well-defined (see Charts 5 and 6) there is a bias towards expecting a significant slowdown in the rate of growth of high powered money during 1979/80. Unless the federal government acts to offset this monetary contraction, or there is a really spectacular improvement in the current account position the government will find M_3 growing at a rate significantly less than 10%. This slowdown will intensify if a mild US recession prevents US short rates from falling sharply and encourages a further increase in the Saudi oil price. The interest rate differential between Australia and the US will almost inevitably be reduced still further if the government maintains its present policies. This may reduce the tightness of the prospective liquidity squeeze through its effect on capital flows, but it should be remembered that if the government sticks to its budget statement, it will use an increase in Australian interest rates to sell bonds to the non-bank private sector thereby reducing the level of reserve assets below what they would otherwise have been. The monetary squeeze will reverse the recent fall in the unemployment rate, and consumer spending will remain at its present low levels, as inflation and the suspension of income tax indexation prevent any significant increase in real disposable incomes. The reduction in aggregate demand will eventually lead to a reduction in the rate of price inflation but this is unlikely to be very marked before the second half of 1980 due to the impact of the increases in the money supply in 1978 and the first half of 1979.

However, the argument that an unintentionally large Federal Government deficit could possibly induce an unintentionally strong monetary contraction has as its corollary the possibility that the government will revise its spending and taxation plans with the objective of producing a slower reduction in inflation rates. In an election year this would be politically attractive. Although the recent increase in the Statutory Reserve Deposit ratio* may indicate that the government is primarily concerned with the impact of monetary growth on price inflation, rising unemployment and interest rates could force the government either to increase its spending or reduce personal income tax and corporate taxation. Of the two, tax cuts are perhaps more likely as they can be an effective instrument in reducing inflationary wage pressure and their immediate impact on real disposable incomes has an obvious electoral appeal. If the government decides to compensate for unexpected revenues from its oil levy it may well implement its policy change just before or at the beginning of the June quarter which is usually characterised by a seasonal contraction in the rate of increase in the money supply.

* All Trading Banks are required to maintain a Statutory Reserve Deposit account with the Reserve Bank. The Reserve Bank determines the minimum amount each Trading Bank must have on deposit in its SRD account. This amount is expressed as a percentage of the Trading Bank's current level of Australian deposits.

KOREA

THE SQUEEZE GETS TIGHTER

During 1979 the Republic of Korea continued to maintain the same tightly pegged exchange rate of 484 won to the US dollar that it has had since 1974. As predicted in an AMM article a year ago (Vol. 2 No. 6), this has led to a severe and prolonged monetary squeeze as a result of the deterioration in Korea's trade and balance of payments position.

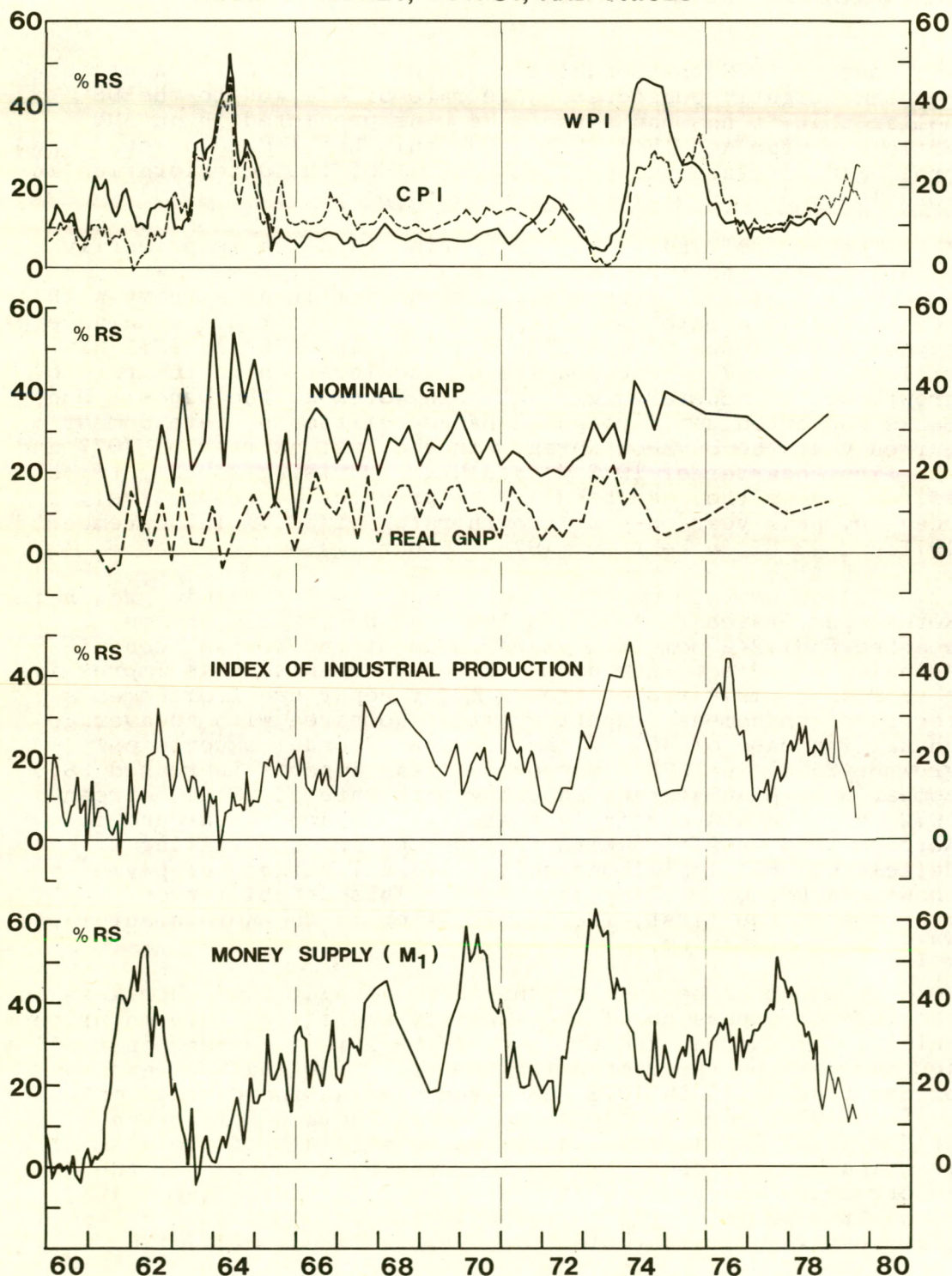
The economic adjustment mechanism in Korea is primarily a monetary one, and Korea has shown all the symptoms that accompany a classic transmission mechanism in an economy with a pegged exchange rate. Initially in the current cycle balance of payments surpluses of US\$1,173 million in 1976 and US\$1,314 million in 1977 produced a steady acceleration in the rate of growth of the monetary aggregates in Korea as the Deposit Money Banks converted net foreign exchange remittances into domestic currency at the Bank of Korea. In the last quarter of 1977 and the first quarter of 1978 M_1 and M_2 were rising roughly twice as rapidly as they had been a year previously, respectively reaching peak year-on-year growth rates of 50.7% in September 1977 and 43.8% in February 1978. (Chart 1)

Following this monetary expansion, real economic growth in Korea accelerated to 12.5% in 1978 and per capita income reached US\$1,242 some two years ahead of the Korean Economic Planning Board's target date. However, despite this impressive performance, 1978 represented a major departure from Korea's record of phenomenal export growth. Compared with an average annual increase of 40% in the previous decade, exports only grew by 26.5% in 1978. Moreover Korean imports increased 38.5% compared with an average annual growth rate of 26.4% between 1972 and 1978. Accordingly there was a sharp turnaround in Korea's trade position with the current account falling to a deficit of US\$1.1 billion and the overall balance of payments showing a US\$400 million shortfall. This deterioration represented the first, inevitable, step in the Korean automatic adjustment mechanism.

It occurred because of the lagged impact that increases in the rate of expansion of the monetary aggregates have on price inflation in Korea, and because of the effect changes in real incomes have on the demand for imports. The index of export prices rose 14.4% in 1978, compared with an increase of only 6.5% in 1977, thereby dampening foreign demand for Korean products, whilst imports increased as a result of the rise of real incomes in Korea. It is interesting to note that the import price index for 1978 rose only 4.3% indicating that almost the whole of the increase in the value of imports for that year was attributable to increases in volume.

As a result of the deterioration in the balance of payments the rates of increase in M_2 and M_1 were steadily reduced during 1978 from their peak at the beginning of the

SOUTH KOREA
CHART 1 : MONEY, OUTPUT, AND PRICES



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year. This reduction was initially rather small and M_2 still grew 37.4% in 1978. The Bank of Korea also intervened to restrict monetary growth by increasing the Reserve Requirements on won deposits and by imposing direct limits on bank lending in an effort to contain the size of bank balance sheets. However it is important to realise that the impact of their actions is secondary to the fundamental influence of the adjustment mechanism in Korea: Basically, the decision to maintain a pegged exchange rate implies that the Bank of Korea cannot pursue an independent monetary policy for long before it comes up against the exchange rate constraint. It can only attempt to accelerate, as in this case, or dampen the automatic process of adjustment to changes in the balance of payments position.

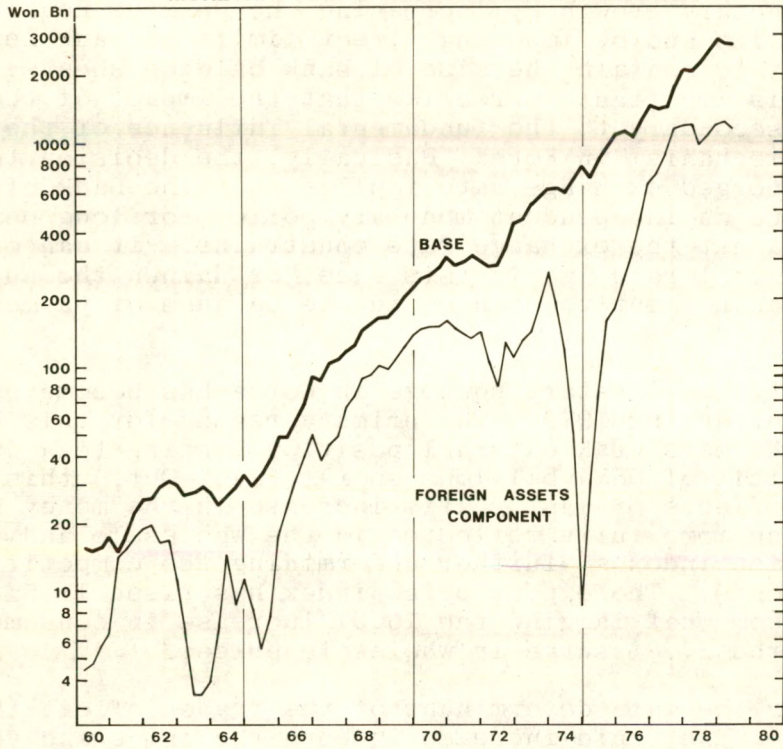
In fact, the monetary squeeze in Korea has become even more vehement during 1979. The primary reason for this has again been Korea's weak external position leading to a current account deficit of US\$4 billions so far (Jan.-Oct.) this year. The lagged effects of last year's increase in the money supply are now being more fully reflected in the wholesale and consumer price indexes, further undermining the competitiveness of Korean goods. The export price index has risen 11.5% so far this year, somewhat lagging the 16.0% increase in consumer prices and the 27.8% surge in wholesale prices.

However the main determinant of the trade deficit this year has been the rapid increase in both the price and volume of imported goods. Korea's import price index has risen 29% so far this year, over half of which is attributable to the increase in oil prices. The increase in the volume of imports was accentuated by the relaxation of import controls in January 1979. This particular move towards a freer market economy would appear to have been singularly badly timed in view of the Korean authorities' concern at the size of the current account deficit.

The continued deterioration in Korea's external position created further reductions in the growth of the monetary aggregates. M_1 increased 11.3% in the year ending in August 1979 whilst M_2 grew 25.4%. However these statistics disguise the particularly sharp monetary contraction that occurred during the second quarter of 1979. During this period M_1 actually declined in absolute terms and M_2 increased at an annualised rate of only 13.5%. Short term interest rates in Korea's unofficial "curb" money market soared six points with unofficial "curb" market lending rates reaching 37% in May.

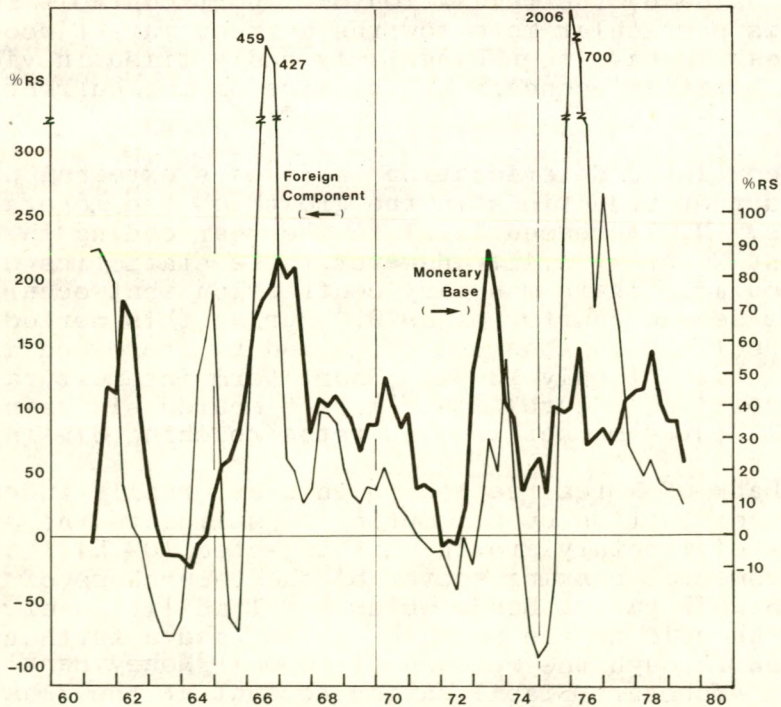
The Bank of Korea reacted to this externally-induced liquidity contraction by attempting to stimulate the domestic components of monetary growth. It injected 102 billion won into the domestic banking sector by the repurchase of its Monetary Stabilisation Bonds which are liabilities of the Central Bank held in the banking system, and a further 40 billion won through the release of Deposit Money Bank's funds held in the Monetary Stabilisation Account at the Bank of Korea. The Bank of Korea also relaxed its direct controls on

KOREA CHART 2 MONETARY BASE AND FOREIGN COMPONENT



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KOREA : CHART 3 PRINCIPAL SOURCE OF CHANGES IN THE MONETARY BASE



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bank lending and increased the maximum interest rate allowed on time and savings deposits in an effort to encourage banks to expand the size of their balance sheets.*

The interaction between the Korean domestic and foreign sectors may be analysed in terms of the monetary base and its sources. Changes in the Korean balance of payments alter the Bank of Korea's net foreign asset position which represents the foreign component of the monetary base. Unless the Bank of Korea neutralises the cyclical impact of the foreign component by inducing corresponding changes in the domestic component of the monetary base, the external sector will induce cyclical changes in the rate of growth of the money supply through its impact on the monetary base.

Chart 2 records the absolute levels of the monetary base and its foreign component since 1960. It highlights the very rapid growth of the Korean monetary base since the end of 1964, the Bank of Korea's successful attempt to insulate the domestic economy from the increase in oil prices in 1974, and the foreign component's initial recovery and subsequent relative decline since then. More importantly, Chart 3 indicates the close correlation between the rates of growth of the monetary base and its foreign component from 1965 to the end of 1974. With the exception of the rapid fall in the foreign component in 1965, the data is generally consistent with the view that it is Korea's external position that is the major source of fluctuations in the growth of the monetary base and hence of the money supply.

However the Bank of Korea may act to dampen the impact of the monetary transmission mechanism by adjusting its domestic monetary policy. The most important monetary policy instrument has been variations in bank reserve requirements. Thus the required reserve ratio on time and demand deposits were reduced from 18% and 22% to 15% and 19% respectively in 1974 in an effort to counteract the severe contraction in foreign component of the monetary base. Changes in reserve requirements and the ratios of bank deposits-to-reserves and deposits-to-cash of the non-bank public are shown in Chart 4. Interestingly, the Bank of Korea's decision to increase reserve requirements three times in 1978 acted to accentuate the monetary deceleration resulting from the decline in its net foreign asset position. This would appear to be a classic example of Central Bank actions unintentionally serving to amplify the cyclical fluctuations in money supply growth, industrial activity and inflation.

In the light of a series of historically weak economic indicators the Korean government reduced its target real GNP growth rate to 9% this year. However it should be stressed

* The fact that the money supply has decreased so rapidly during a period when there has been no major direct or indirect domestic policy measures to tighten monetary control (the increase in Reserve Requirements to 20% on time deposits and 27% on demand deposits occurred in April 1978) is evidence that Korea's monetary squeeze is almost entirely the result of pressure from the external sector.

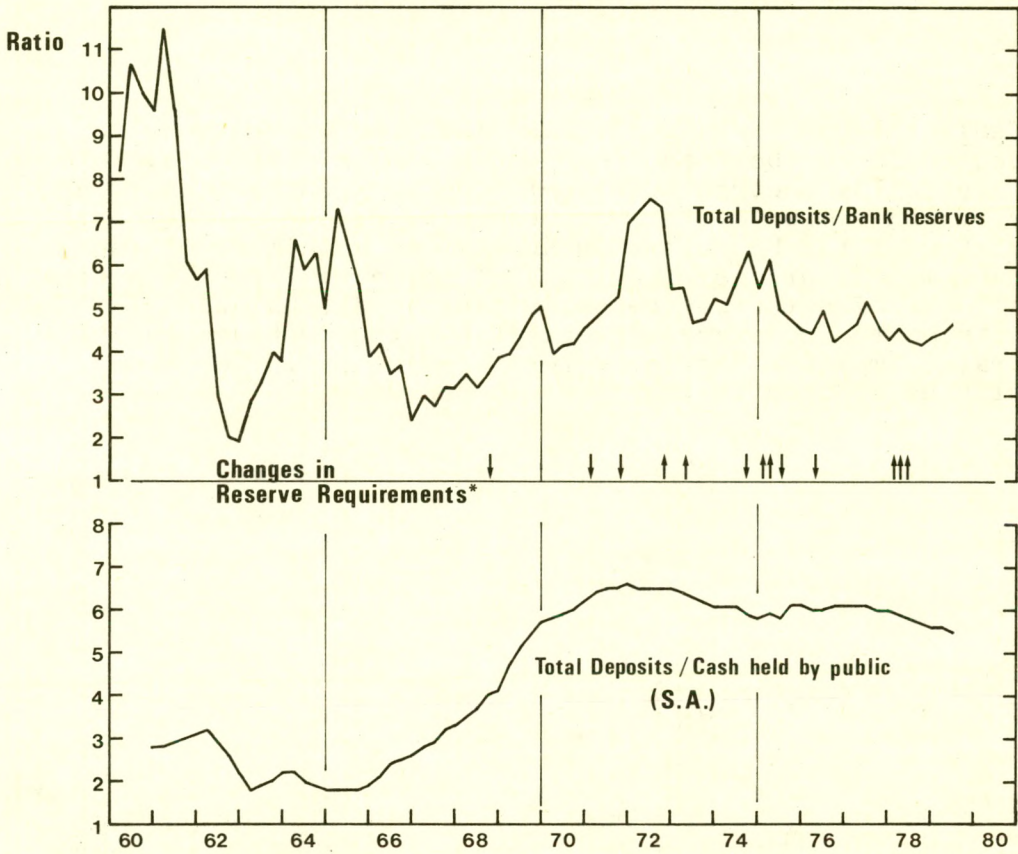
that the publication of a reduced official growth target is somewhat superfluous given the adjustment mechanism in the Korean economy. The 9% target can best be viewed as an official seal of approval on the operation of the adjustment procedure.

Towards the end of the third quarter of 1979 there were signs that the monetary squeeze was beginning to pay off in terms of reduced price inflation. The rate of increase in wholesale prices fell steadily from July to October and the rise in consumer prices showed some indications of having peaked. In the wake of President Park's assassination the Korean authorities are keen to capitalise on these slight improvements and to attempt to consolidate their economic performance. To this end they have instigated a voluntary Prices and Incomes Policy and frozen the prices of several key items, notably some food products. The Bank of Korea has also suggested that it may be prepared to relax its 1980 targets for M_1 (19.1%), M_2 (20%), and domestic credit growth rates, which were more stringent than the 1979 targets of 20% for M_1 and 25% for M_2 . Once again, in the context of a pegged exchange rate economy, the publication of monetary growth rate targets is not particularly meaningful and the reduction of these targets represents further official support for the nature and direction of Korea's economic adjustment.

Herein lies the major problem facing the Korean economy in the next two years. The current monetary squeeze has been conducted during a period of relative buoyancy in the US economy. Despite the apparent severity of the monetary contraction an unofficial won-US dollar rate of around 580 suggests that it has not been tight enough. If as is widely anticipated the US enters a recession next year and the won appreciates with the US dollar this implies that, far from allowing an easier monetary policy, the Bank of Korea should be preparing for an even tighter squeeze. This view assumes that Korea maintains its present exchange rate policy. Of course, the Bank of Korea could relax the constraints on the operation of a less restrictive monetary policy by devaluing the won against the US dollar. At present there is much official discussion of this alternative, which would be aimed at reducing the external sector's contribution to the reduction in the growth of monetary aggregates. However, there are a number of reasons why one should not expect the won to be devalued in the short term. Firstly, many of Korea's exports have a low price elasticity of demand and are in any case subject to bilateral quota agreements. Thus a devaluation would not improve the won value of Korean exports substantially. Secondly, a devaluation now would be inappropriate in terms of Korea's development strategy. Korea is already committed to a large investment in capital goods for its new heavy industries. Since the great majority of these will have to be imported a devaluation may not decrease the demand for imports whilst it would certainly increase their price in won terms. These two factors imply that devaluation would not be a strong policy instrument for enabling the Bank of Korea to follow a less contractionary monetary policy. However, probably the most important short term argument against a devaluation, according

KOREA

CHART 4: COMPONENTS OF MONETARY MULTIPLIER

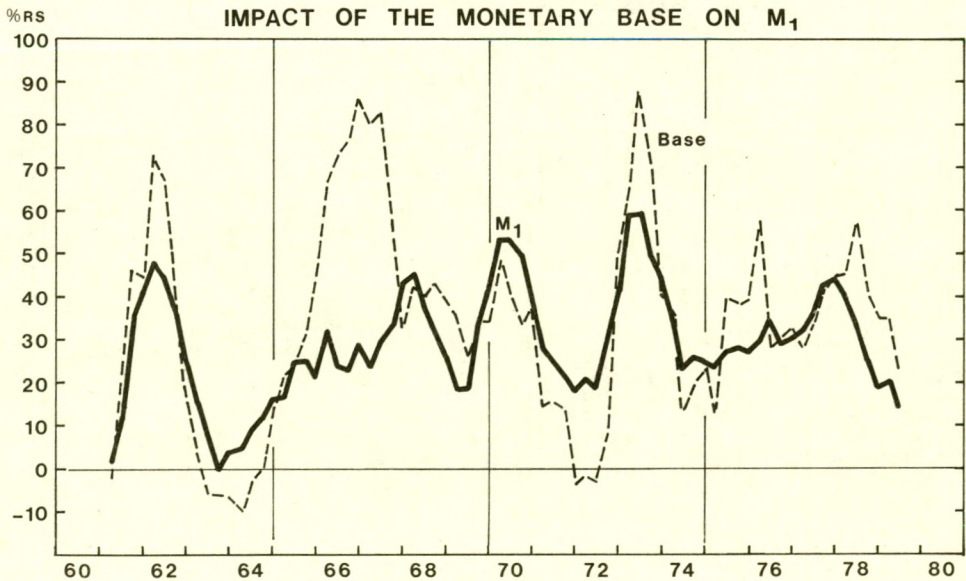


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*↑: Reserve Requirements tightened

KOREA : CHART 5

IMPACT OF THE MONETARY BASE ON M₁



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to Bank of Korea officials, is the domestic uncertainty that may accompany it, and in the aftermath of President Park's death the Koreans are anxious to avoid any potentially destabilising influences.

FORECAST: Since a devaluation is likely to prove to be an unsound policy on both economic and political criteria, Korea must eventually undergo a further monetary contraction. The severity and timing of this squeeze will depend on the depth and timing of the US recession and on the magnitude of the increase in oil prices. The Bank of Korea will try to mitigate the effects of a further deterioration in the balance of payments on the monetary aggregates but the exchange rate constraint implies that the rate of inflation in Korea must steadily be reduced to the level in the US.

BOOK REVIEW

"ASEAN ECONOMIES IN PERSPECTIVE - A Comparative Study of
Indonesia, Malaysia, The Philippines, Singapore and Thailand"
by John Wong, MacMillan Press Ltd. (Paperback)
London, 1979.

This book provides a highly compact comparative survey of the economies of ASEAN, the Association of South-East Asian Nations. The text consists of just 129 pages, and is supplemented with 84 pages of useful tables, references and an index. Within this short space John Wong, who is Senior Lecturer in Economics at the University of Singapore, manages to condense a brief history of the institutional development of ASEAN since its foundation in Bangkok on 8 August, 1967, a discussion of the role of trade as an engine for development, the mode and relevance of industrialisation as a strategy for the region, a bird's eye survey of the agricultural and rural development policies pursued in the region, as well as a brief guide to the chief socio-economic issues involved in the struggle for economic development. Throughout the text there are numerous annotations suggesting additional up-to-date books and articles which could be followed up by any enthusiastic student of these topics. The style is on the whole clear and simple, and, given the difficulty of separating a group of interrelated topics, the author has done very well to organise the material into five quite distinct chapters. The book is therefore very readable - an excellent introduction both to the economies of ASEAN and to the current state of the academic debate on economic development.

Three topics arising from the book merit critical comment here: (1) the methodology implicit in the approach to matters of fact and matters of opinion, (2) the differentiation between cyclical and secular problems, and (3) the views expressed concerning the role of government in the process of economic development.

ASEAN is of course a political grouping, and the aims of its members encompass a wide variety of political, social, military-strategic and economic goals. It is therefore important in writing objectively about such an organisation and the policies of its members that some attempt be made to separate what is positive (i.e. value-free theory or fact) from what is normative (i.e. recommendations for action). There are many examples in the book when the author slips too easily from one type of statement to the other and it is by no means clear that his particular recommendations follow from the analysis. One example: *"A case in point is the import substitution policy, which is designed to promote inward-looking industrialisation at the expense of primary exports because of the many disincentive effects created for the primary producers.... Some of the structural rigidities of the existing production system need to be removed so that it can respond more efficiently to any change in the world market conditions. Specifically, the small producers should be given more assistance so as to upgrade their productivity."* (p.36)

The first statement is positive. The second sentence is a borderline case. The third sentence is unequivocally normative. But is it true that more assistance to small producers is the only or best policy proposal available to developing countries which are trying to achieve some degree of import substitution? If there are rigidities in the existing system this presumably implies the price mechanism is not functioning, so one area that immediately calls for study is the extent to which prices are fixed or markets are not freely competitive. Both Thailand and the Philippines offer numerous examples of price-fixing in domestic markets for staple commodities, which surely cannot be entirely compatible with maximum allocative efficiency or upgrading productivity. Another example: *"In practice it is not easy to determine the minimum plant size required for optimum production, because it varies with the economic conditions of a specific country as well as the particular line of production.... In fact any (such) indiscriminate promotion of small industries across the board could result in a waste of capital as well as the development of an excessively fragmented industrial structure. Instead of blanket promotion, priority should be given to more viable small industries geared to exports or to supplying and servicing other industries."* (pp. 84-85)

Again the first sentence is unexceptionable and value-free, either as a statement summarising observations of fact or as a statement of theory. But the second sentence introduces a value judgement: what might be considered "an excessively fragmentary industrial structure", and under what conditions? The third sentence is once more a categorical statement of opinion, but is the prescription correct? Why should the results of bureaucrats promoting one particular industry (or sector or company) necessarily be more successful in accomplishing economic development than indiscriminate, blanket promotion? And who is to say what small industry is "more viable" than another?

The second topic which deserves clearer treatment by a teacher of economics is the difference between transitory or cyclical economic disturbances and longer term secular problems. In his discussion of commodity price stabilisation schemes, or the economic boom of the early 1970s, or the effects of the increase in the price of Thai rice for Malaysia, Indonesia and Singapore (p. 94) Wong shows a poor understanding of the mechanism by which business cycles and inflation are transmitted between countries with different currencies and different exchange rate policies. These cyclical disturbances are generally deemed to have only a small impact on the long run, secular growth rate of an economy. Other problems such as differing savings rates, varying rates of capital formation etc. are more deeply-rooted and require a different kind of analysis. It may well be true that the dramatic improvement in the terms of trade produced by the commodity price boom of the early 1970s enabled Malaysia, for example, to pass some threshold into self-sustaining growth, but the policy issues in cyclical and secular analysis are quite distinct. In the former they are largely monetary, having to do with exchange rate policy, the balance of payments, monetary growth, interest rates, and

inflation; in the latter they are either fiscal (having to do with tax policies, subsidies, preferences and other transfers) or social in nature.

Third, Wong's stance on the role of government in development is ambiguous. On the one hand he frequently advocates greater government intervention, new subsidies or incentive schemes, aid for small farmers etc. all of which would require penalising one group in order to assist another and which would of course have to be administered by yet more government officials. On the other hand he is critical of government involvement in many branches of the economic development effort. For example he candidly talks of the 'white elephants' in Indonesia's state-owned sector (p. 61), and towards the end of the book he offers us the judgement that "the performance record of public enterprises in most ASEAN countries has been quite dismal in general..." What is the evidence concerning government participation? What are the conditions common to successful (or indeed unsuccessful) government ventures? These questions are not new, and have frequently been answered by economic theory and evidence from developed countries, but it would be illuminating to know whether the same findings are applicable in ASEAN. The economics of government is a popular and rapidly growing area of research in North America today. Perhaps one day it will become so among economists who specialise in economic development.

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